

**AN ECONOMIC ANALYSIS OF CONTRACTUAL RELATIONSHIPS
IN FRANCHISING SYSTEMS WITH CASE STUDIES**

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CASE A APOLLO BLINDS LIMITED

The franchisor

1. Background

Apollo Blinds was established by James and Robert Macneil in the late 1960s. They intended to run the business as a franchise system as early as possible. Franchising began in 1975. Prior to this date, the brothers manufactured and sold window blinds through shops in the Glasgow area, building up a business model which could be franchised. Even in the earliest days before full business-format franchising began, the Macneils were using agents who sold on commission from home using newspaper advertisements. The information on Apollo which follows is, based on an interview with Nan Stevenson, the current Franchise Manager.

In addition to Apollo, the Macneils operate two related businesses. Eclipse Limited is used to sell components and materials to franchisees and to other window-blind companies. Macneil Property Limited arranges property leases and store-design services for franchisees. Both companies have been developed to fulfill particular needs of the Apollo franchise system.

Apollo now has around 100 franchisees. The average annual sales turnover of a franchisee is £100,000 at the time of writing. There are around 200 direct employees at the Apollo and Eclipse factories in Glasgow. Franchisees are located mainly in Scotland, Northern Ireland and the north of England. The company wishes to expand into southern England and Eire, and has set a current target of 250 franchisees.

Apollo is no longer involved in retailing having franchised its last company shop in 1982. Franchisees just retail blinds for the first four weeks of operation, and then gradually build up facilities to manufacture standard louvre, venetian, and roller blinds. Special orders are tailor made by the Apollo factory for franchisees. The manufacturing side of the shops has been added since 1985 when Apollo began to extend its communication lines with its expansion southwards. With manufacturing, it is often worth while for franchisees to appoint sub-agents who sell on a one-third mark-up on costs. In addition to manufacture and retail sales, the franchisee repairs and cleans blinds and may supply trade customers such as architects or department stores.

Mrs. Stevenson emphasises that franchisees are expected to operate from premises which are wholly devoted to their Apollo operations, although there are a few cases of shop-within-shop display areas in department stores. Fractional franchising is not permitted as Apollo prefers its franchisees to be completely devoted to the business. I was told that there would not be time for a franchisee to have other business interests if he were properly performing for Apollo. However, multiple franchises are permitted: some franchisees have more than one territory. Once a franchisee proves himself, he may be offered additional, usually contiguous, territories. The ideal profile of a typical franchisee is very much that of a local entrepreneur who maintains daily involvement with his business.

The franchisor is a founder member of the British Franchise Association and of the Irish Franchise Association. The franchisees have an association.

Apollo has numerous competitors such as Perma Blind,

Luxoflex and Chris Craft. It remains market leader wherever it is located.

2. Nature of the franchise

An Apollo franchise confers the sole manufacturing and marketing rights to the Apollo-branded product and service within an agreed territory. The franchisor expects complete commitment from franchisees, in particular with regard to maintaining the corporate image and service standards. In return, the franchisor sees his obligations as providing centralised marketing, operating property management services, and giving general technical and managerial back-up. Apollo offers a full business-format (manual-based) franchise.

There is pre-trade training in sales, operations and administration at Apollo headquarters. Following this, a new franchisee spends his first week of operation with an operations manager supervising his activities. Thereafter, Apollo provides occasional training as it is required. Training is at the franchisor's expense excluding the franchisee's subsistence costs.

In addition to training, an Apollo franchise provides manuals covering parts ordering and stocking, manufacturing of standard blinds, sales methods, and business administration. There is no direct financial help given to franchisees but there are packages available from major banks like the National Westminster Bank and the Royal Bank of Scotland. Banks appear more willing to lend to franchised compared with independent new businesses. A further important part of the structure of the franchise is the acquisition of high-street property, which is then rented to the franchisee through Macneil Properties. Shopfitting fees are levied at cost. A

franchisee's investment in his premises creates an highly specific asset.

National advertising is the franchisor's responsibility for which he levies a 3% charge on the retail price of all materials and finished blinds. Local advertising is largely at the franchisee's discretion.

The trading links of the Apollo franchise system are summarised in Figure A. The direction of sales is shown by an arrowhead for each link in Figure A. Dotted lines show links which are subject to franchisee choice (for example, over whether to use sub-agents). Interestingly, the retailer gives up his normal freedom to refuse to sell. This is because his contract with the franchisor requires him to pursue all sales. Finally, the figure shows that all parts must be bought from Eclipse by the franchisee: he cannot shop around.

3. Contract

3(i) The Agreement

Apollo uses an extensive Franchise Agreement. There now follows a simple summary of the principal contractual clauses. A copy of the Agreement is available for inspection should this be required.

The Agreement defines the rights to operate the system and use the trade name along with the know-how which is to be transferred to the franchisee. The business premises are also defined allowing Apollo to specify a property to be leased from Macneil Property in an attached schedule. A territory is fixed for the franchisee. The term of the Agreement is set, usually for five years, and may be renewed at a cost equal to 10% of the then current initial fee.

The Agreement sets out the franchisor's and franchisee's obligations. At this point the contract looks decidedly one sided with a ratio of 20 franchisee to seven franchisor obligations. The franchisor undertakes to provide know-how manuals, facilities for consultation, training, display systems, corporate-image materials like stationery at a specified cost, and national advertising support. The franchisor's levies for advertising and administration are set. The franchisee is obliged, among other things, to preserve the company image by using only its trademark, to provide a suitable vehicle, to use only company materials, to allow Apollo to vet employees, to seek written permission for other business interests, to attend promptly on customers, and to refrain from supplying other franchisees.

The franchisor will pay for training excluding travel and subsistence cost but retains the rights to insist on particular items of training and to terminate the contract if, during training, the franchisee is discovered to be unsuitable. The franchisee is required to pass on property rights in his innovations to the franchisor and to accept changes in the know-how, to pay a specified lump-sum franchise fee, to allow franchisor vetting of his advertising, and to accept that trade marks are the franchisor's property. The franchisee agrees to place local newspaper advertisements as directed by Apollo., There is no interest rate set to apply to overdue payments should these occur.

The franchisee may sell his business subject to franchisor approval of the purchaser although a fee of 50% of the then current franchise fee will be charged; the franchisor will grant a new term of not less than three years. If the franchisee should die then there can be a simple transfer to his beneficiary. If a beneficiary wishes to sell the business the the franchisor will

provide and charge for a manager for up to six months to enable the sale to proceed. If there is no sale then the franchisor has the right to buy back at market value less 20% with a disputed valuation going to compulsory arbitration. Termination may be for any breach of the contract but the emphasis is on bankruptcy or disclosure of information to competitors as grounds for this. Following termination the franchisee will cease operating under the trade name and will not compete with the business in his old territory.

The franchisor states that his failure to exercise a right on any occasion will not constitute its abandonment. He also states that the Agreement is complete and will not be altered by oral undertaking or by custom and practice. If a condition of the contract is found to be contrary to statute law, then it is severed and the remainder of the contract will stand if and only if the franchisor so wishes. He can end the economic relationship if the law erodes its value to him but preserve it in the face of a lost clause if this is his wish.

There is a provision for compulsory arbitration. In Scotland, a mutually agreed arbiter's rulings will be binding or, failing such an agreement, the rulings of an arbiter appointed by the President of the British Franchise Association will be accepted. It is important to note that this rules out costly litigation. Arbitration is of course not costless. Liability to pay for it is not defined in the Agreement.

Finally, schedules give opportunities to specify variable details referred to in the clauses, such as the franchise fee and the term of the Agreement.

3(ii) Implicit aspects of the contract

The overall contract between Apollo and its franchisees contains implicit aspects as well as the written clauses of the Agreement.

It is Apollo policy to require franchisees to rent their properties from Macneil Property. This is an implicit aspect of the contract in that the Agreement does not require this, although the specific premises are indicated in a schedule. Enforcement is through the market sanction of withdrawal by the franchisor of the offer to enter the Agreement in the event of noncompliance. In short, the franchisee is offered an all-or-nothing choice. Either he rents from Macneil and is allowed to join Apollo, or he is excluded if he insists on obtaining property elsewhere.

The obvious function of this property link is to enable franchisees to obtain high-street leases when they would appear bad risks to property owners without the franchisor's backing. This raises the question of why the link is made obligatory. It is also possible that it acts as a device to keep goodwill in the hands of the franchisor, although this function can be performed by a device like Clause 15 of the Agreement (where post-termination competition is limited). It may also act to render investments in the site fittings worthless to a franchisee should he leave the business. The final possibility exists that the link is a means for extracting pure profit from the franchisee subject to leaving him a normal business return. In short, it may be a device to extract economic rent. When interviewed Apollo indicated that it was the first reason, helping franchisees to find property, which explained the link.

A second implicit aspect of the contract is the expectation of franchisees that the franchisor will develop the business. The franchisor is well aware that failure to promote the growth of the business through, for example, advertising and product innovation would result in the loss of existing franchisees at times of contract renewal. Again, there is a market discipline on the franchisor.

A third implicit aspect concerns the sales territory referred to in the Agreement. Early on this was found to be impractical to operate as customers entered branches away from their homes. Franchisees can sell anywhere they now wish, but must promote themselves only in their own area. This is an understanding not written down anywhere.

A final implicit aspect is the acceptance by franchisees of transfer prices for tied-in sales. These terms are not specified in the Agreement. Excessive prices could lead to a loss of existing franchisees and to difficulties in recruiting. However, the pricing of tied-in sales gives another possible avenue for rent extraction by the franchisor.

3(iii) Enforcement and monitoring

The franchisor monitors the franchisees in a number of ways. Weekly sales returns are made based on a system in which copies of all sales receipts are sent to Apollo headquarters. In addition, costs are monitored implicitly from these returns as Apollo has a good idea of material requirements for the sales which are reported. Apollo raises most of its continuing fees from franchisees by means of a mark-up on its product sales. It is therefore important to prevent purchases from outside of the company. Arithmetical discrepancies between inputs and outputs would alert Apollo to outside purchases.

Correct reporting of sales is encouraged by a centralised complaints procedure. If a franchisee avoided reporting sales, there would be the danger that a customer complaint to Apollo would alert them to his practice. He would be in breach of his contract and would risk losing his investment in the business.

Daily observation of franchisees' conduct is not undertaken by Apollo. Only a problem arising or a request from a franchisee will lead to a visit from Apollo. Operations managers exist to give help rather than to monitor and they are few in number: one for Scotland, two for England and one for all of Ireland.

Mrs. Stevenson knows only very few cases of dispute with franchisees. Occasionally there are franchisees who are discovered purchasing products other than from Apollo or Eclipse.' Sometimes, franchisees run into financial difficulties. The company prefers not to rush into quoting contracts at people but always tries exhortation first, following this with a fine for a breach if this seems appropriate. In extreme cases, termination would be considered. In Apollo's history, breach of contract has been resolved twice by fines and in only three cases has it led to termination. The commonest cause of these solutions has been nonpayment of bills.

A few franchisees have either left the system, usually by selling their businesses to new franchisees approved by Apollo. No figures for this are quoted by the franchisor. Some of these sales have been at Apollo's suggestion as a means of settling disputes.

Apollo emphasises its wish to avoid legal process in its dealings with franchisees. There is a concern not to develop a reputation for oppressive litigation and the company appears to prefer to err in the other direction.

This history in this area and statements made in interview are consistent with the provision for compulsory and binding arbitration in the Agreement.

4. Why franchise?

Mrs. Stevenson believes that the major advantage Apollo offers a franchisee is its brand name. The name is well recognized by architects and ordinary members of the public. They will often just look for the nearest Apollo branch if thinking of fitting blinds. Other advantages mentioned in interview were a debt-factoring service for larger account clients, Apollo's marketing expertise, and the financial package offered by major banks to Apollo franchisees. It was also felt that franchisees would be supported in times of poor market conditions in that business advice would be available and some rescheduling of bills would be possible.

Compared with managers of company shops, franchisees are thought to be more entrepreneurially alert to business opportunities. I was told specifically that "The quality of person is very much better than any manager we could afford to employ". It is felt that this is due to the franchisee's greater commitment to the business as he has his own funds sunk in it. If the market becomes tight, for example, the franchisee would be much more active in seeking new business.

Compared with selling the product through any retail outlets, product debasement is believed to be avoided by the franchise arrangement. Apollo wishes to offer a total service of supply, fit and service. Furthermore, it wishes this total package to be perceived as being of the highest quality. Without control over outlets, quality would suffer and brand image would slip. Even if the quality began at a high level, individual retailers would

have incentive to sell the product but skimp on service, free-riding on the efforts of others. Either the franchise system or company shops will correct this problem. Interestingly, the contract refers to the avoidance of product debasement.

Mrs. Stevenson perceives no capital-raising advantages for Apollo from franchising. Apollo would have "No problem in raising capital to open shops". In fact, it is thought likely that the system gives advantages to franchisees. This is an interesting result as it runs counter to much received wisdom among franchisors.

Monitoring costs are thought to be very low compared with a system of company-owned shops. I was told: "There is no way the UK and Eire could be covered with four operations managers outside of a franchise system". The franchise arrangement gives the benefit of tying everybody's fortunes together in an incentive-compatible system. Effort-monitoring problems therefore recede. In the Apollo system, problems of honest reporting are well controlled through arithmetical and complaints checks. Also, a franchisee has a lot to lose if he is discovered trying to cheat.

5. Fees and returns

At the time of writing, Apollo charges an initial lump-sum franchise fee of £4,000. Franchisees may also reserve the option of expanding into contiguous territories for 500 once they have proved themselves. Renewal fees are 10% of the franchise fee. The franchisor spends money when setting up a new franchisee and does not aim to make a profit out of the franchise fee. Total set-up costs for the franchisee are approximately £20,000 as shown in Appendix A. Two-thirds of this figure could usually be borrowed from the banks.

Sales targets are not set for franchisees. This is considered unnecessary as both franchisor and franchisee profits are believed to increase with sales. Apollo is well satisfied with its profitability and is not considering changing its operating methods. In particular, there is no intention to forward integrate into retailing by opening company shops. The franchisor believes returns for franchisees are higher than they would receive if they operated outside of the franchise system. Appendix A also shows the franchisor's financial projections for a franchisee's first two years of trading. The figures are calculated on prices ruling in January 1987 and show a weekly net profit of just over £300 after two years, which amounts to a good return for a small businessman in retailing. The business is meant to be established by the second year. There is no separate wage calculation for the franchisee in the projections. The wage heading allows for one assistant and some casual help in the first year with additional help from the second year onwards.

The franchisor levies no sales royalty but does charge 3% of the wholesale price of products for administration and 3% of the retail price for national advertising. Prices are taken to exclude VAT.

There are tied-in sales. Products must be bought from Apollo or Eclipse, depending upon whether further assembly is required or not. The transfer prices are 8% higher than similar sales by Eclipse outside of the franchise system. Apollo is effectively levying an 8% royalty on competitive input costs. Overall, pricing aims at a one-third mark-up for franchisees on retailing and a further one-third for any manufacturing. There is a discount scheme which operates as a negative royalty. The discount applies to purchases by franchisees if annual sales exceed 37,000, which they certainly should. It

starts at 1% and rises by increments to 10% for annual sales of 600,000 or more. The franchisee can roughly recoup the franchisor's mark-up at the highest sales levels (the percentages apply to different bases). Apollo is clearly willing to exchange unit profit for volume on its tied sales. VAT is added to all fees charged by the franchisor and may be claimed back by the franchisee.

No interest rate on overdue payments is specified by the franchisor in the Agreement. However, the franchisee agrees to abide by the credit terms offered by Apollo.

There are no opportunities for new franchises in Scotland and Northern Ireland. The territorial allocation which implies saturation for the two areas was set many years ago and was based on Apollo's projections of market growth and production costs. Once set contractually, the pattern is difficult to alter even if it were thought that new market conditions allowed further expansion. Apollo believes its coverage to be correct, given the performance levels of franchisees.

The franchisees

1. Franchisee A₁

A₁ began as an Apollo franchisee in XXXX back in 1980, having previously been in retail management elsewhere. He added a second Apollo franchise, XXXX in XXXX, in 1986. The two franchises share a factory unit which manufactures venetian and louvre blinds. Materials, components and assemblies are always purchased from Apollo or Eclipse sources. There are three full-time, five part-time and two casual employees.

A₁ confirms the financial and structural details of the franchise system which Mrs. Stevenson reported. He

also agrees that it would not be practicable to run other business interests alongside his franchises. He sees his obligations as "Giving 100% loyalty and working in partnership with Apollo". In addition, he believes that he has a duty to report any other franchisee who appears to be letting down standards of service. Apollo is expected to give total support to his operations in terms of national promotion of the brand and availability for local consultations.

The contents of the written contract are well understood. Furthermore, A₁ verifies Apollo's stated preference for avoiding litigious solutions to disputes, which are anyway described as rare. He thinks that Apollo "Bends over backwards to keep franchisees". They are more likely to exhort or to fine franchisees for breaches of contract. He knew of no use of the compulsory arbitration clause.

A₁ confirms the strong understanding over renting premises from the franchisor. Interestingly, he gave me details of post-contract renegotiations which had occurred over rents. In his own case, the new XXXX premises had not initially performed as well as had been projected. Apollo had therefore agreed to reduce the rent it charged. This lends some support to the notion that control of the lease may allow extraction of economic rent by the franchisor: when returns are poor the cost of the lease falls.

I was told that the major benefit of signing with Apollo is the brand image. Awareness of the brand is very high. A₁ reports conversations in which people refer to blinds as Apollos rather as they might call vacuum cleaners Hoovers. Reporting that his business returns are better than he feels he could obtain independently, he

emphasises that "It is definitely worth fitting in with Apollo".

I met A₁ at his XXXX shop. My observations were of a low-volume retail outlet trading on customer awareness that a full service is available. Apollo prices are certainly not the lowest. However, do-it-yourself installation or little-known installers are avoided.

2. Franchisee A₂

A₂ set up the XXXX franchise in 1983, when an existing franchisee sold part of his territory. XXXX was added in 1985 and was bought from a franchisee who did not get on with Apollo ("Basically they did not like the man"). I met with A₂ at XXXX and accompanied him on his business calls while we talked. Over the course of the afternoon he serviced a blind, dealt enthusiastically with shop customers, fitted a blind, and measured for some new business.

Each of his shops has its own workshop for manufacturing and servicing. A₂ employs his son full time to run the XXXX business and has a further six part-time employees. In addition, he casually employs various fitters (who are mostly moonlighting firemen). Materials are mostly bought from Apollo although a small amount is bought from outside of the system contrary to the Agreement. In addition to Apollo products, curtain rails and velux roof-window blinds are sold "With Apollo's knowledge but not with their blessing". I was told that most shops have some small sideline of this sort. It is probably not worth the franchisor's time to police small-scale infringements of contract of this type.

A₂ confirms the details of the franchise system reported by Apollo. He agrees that there would not be

time to pursue significant other business interests alongside an Apollo franchise. He sees his principal obligation as making his business a success. Apollo is expected to maintain its current product quality and to provide general support.

This franchisee is not instantly familiar with the content of the Franchise Agreement and believes that he should have paid more attention to it. He also verifies Apollo's preference for avoiding litigation and considers it likely that they would encourage a franchisee to sell his franchise if there were a serious dispute. A₂ is aware only of minor disputes within the system. Occasionally there are arguments about franchisees buying products away from company lines. Franchisees sometimes wish to see more franchisor advertising, which may be an inevitable consequence of exacting a levy rather than linking franchisee contributions to the amount of advertising. There are "gripes" because Eclipse sells more cheaply to competitors. Generally, the long-term value to franchisees of remaining within the system enables Apollo to find managerial solutions to such disputes.

A₂ agrees that there is a strong understanding that franchisees should rent their premises from Macneil Property. He feels a little vulnerable as a result of this. One of his leases is due for renewal and the new rent which has been suggested seems high to him. He suspects this has happened because his shops have performed better than had been predicted in the original projections.

The major benefit of signing with Apollo is again thought to be the brand image. A₂ comments "They really have the marketing right, customers choose us first even though we are not the cheapest". On his own, he believes

he would all too often be tempted into unnecessary price competition.

A₂ provided some useful insights into risk sharing in this franchise. Measurement errors are always borne by franchisees, who accordingly have a strong incentive to be careful. Apollo will only accept responsibility for faulty products which it supplies. In addition, the franchisee bears the risk of bad debts unless the customer qualifies for the debt-factoring service offered by Apollo.

My observations whilst accompanying A₂ during a fairly representative afternoon were again of a small-volume retail operation (albeit with trade customers) which trades on quality and not on price. He is extremely active in pursuing new business leads and finds his returns to be better than those he believes he could achieve if he were independent.

3. Franchisee A₃

A₃ obtained his franchise from an existing franchisee in 1982, having previously worked as a sales manager for a XXXX company. The previous franchisee's commitments became too extensive elsewhere and Apollo encouraged him to sell out. Although he only has one shop, A₃ has appointed two agents who sell venetian blinds which he manufactures on a one-third mark-up on transfer prices. Both agents are within his territory as they are required to be.

A₃ has manufacturing and servicing facilities behind his shop. He employs his son full time in manufacturing and his wife works part time in the shop. A retired fireman is casually employed as a fitter. All main products come from Apollo or Eclipse, although A₃ does

have a sideline in curtain rails. Apollo turns a blind eye to these. Generally, it is not worth buying materials from outside (although he may have been cautious in talking with me).

A₃ confirms the details of the franchise system reported by Mrs. Stevenson. He also feels that Apollo business keeps him fully occupied. He sees his obligations as manufacturing to standard and maintaining service quality. The franchisor should monitor the system to control for poor franchisees ("Or we all get a bad name"), promote the brand, maintain good supply lines, and generally support franchisees.

The franchisee had looked at his Agreement in the earlier days of his business. However, he now feels that the contract is very much in the background. It is not regularly quoted and the links with Apollo are based more on the value of the business relationship. He knows that Apollo favours sell-out solutions to contractual disputes as he bought his own shop that way. Other than this, A₃ is only aware of minor disputes over advertising: the xxxx franchisees want more Apollo advertising and dislike their obligation to advertise in the Evening Times.

A₃ realises that there is a strong understanding that franchisees should rent their properties from Macneil Property. However, ^{he} is not aware of the possible extraction of economic rent which could result from this. He believes that the franchisor would always keep lease costs within commercial ranges and that he could anyway appeal to a Rent Tribunal. In fact, there is no redress. Once a franchisee has agreed to a rent, it is not a matter subject to the arbitration clause in the Agreement. Rent Tribunals are not relevant to commercial property.

A₃ supports the claim of the other franchisees that brand-name strength is the real advantage of signing with Apollo. He feels that it is worth fitting in with the company in order to benefit from this. In contrast, he thinks that his local knowledge is of benefit to Apollo, and also understands that he bears measurement risks. Business returns are "Adequate but not startling".

During my observation of this franchise, I saw a practical demonstration showing how territories indeed do not relate to sales (but to advertising). A customer entered to order blinds for a London flat.

This franchise is very much a mom-and-pop operation.

Summary

Apollo essentially markets its window-blind products through a franchise system. It does not contemplate opening company shops. Franchisees are seen as more committed retailers compared with shop managers. Franchisees must buy only the tied-in products and are charged a transfer price 8% above market price minus discounts for high volumes of sales. The transfer prices for a tied-in sales are not set in the Agreement, leaving the company a device with which to extract any economic rent arising at the retail end of the business. Apollo insists that franchisees take out property leases through its associated property company, which may give another device to extract any economic rent. Apollo believes in market-based rather than legal solutions to any disputes which may arise.

Franchisees perceive an important brand-name benefit from belonging to the system. They bear measurement and small-debt risks. They are happy with their profits but do not regard them as exceptional. The requirement that

they follow the franchisor's pricing policy is probably illegal and unenforceable.

Small contractual breaches are overlooked by the franchisor in practice.

----- Subject to franchisee choice

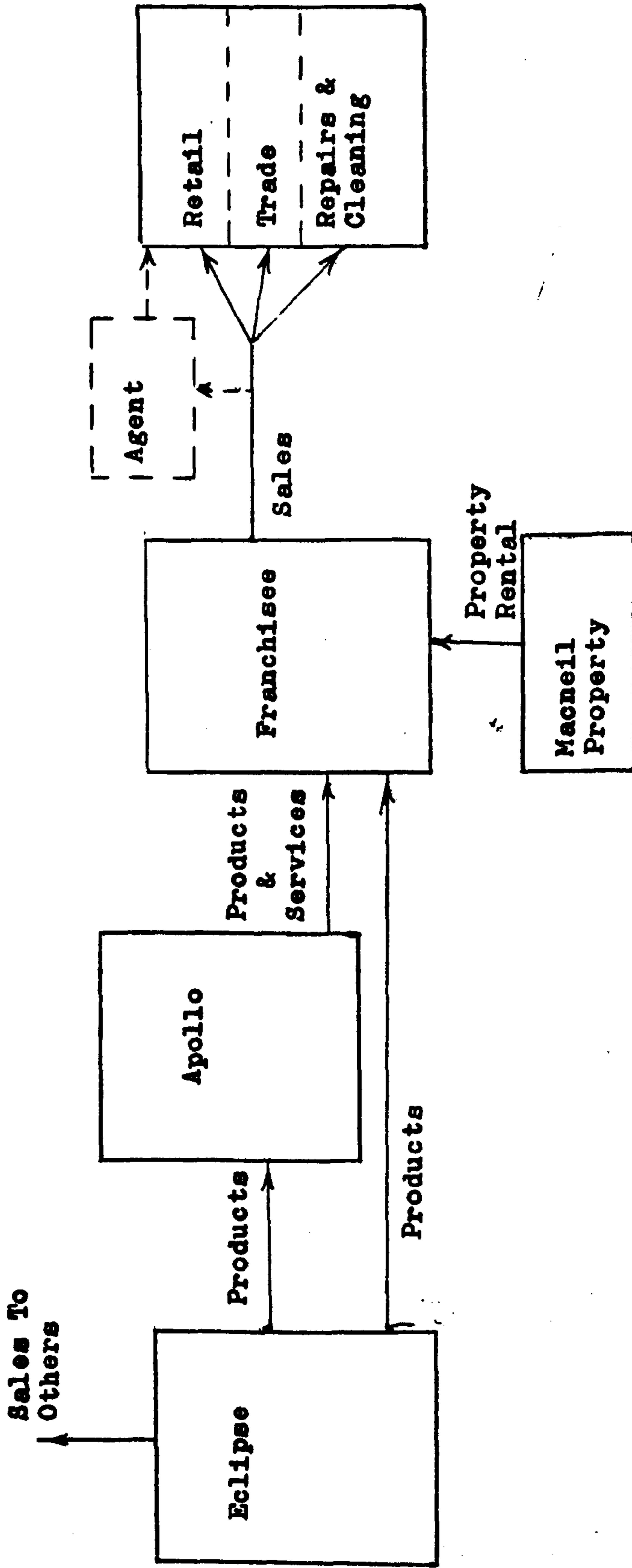


Figure A Apollo Blinds Franchise System

Appendix A Apollo ProjectionsCapital Requirements (£'000)

| | |
|--------------------|-------------|
| Supply of know how | 4 |
| Property | 9 |
| Vehicle | 1.5 |
| Exhibition kit | 0.8 |
| Tools | 2.8 |
| Stocks | 5.5 |
| Miscellaneous | 0.7 |
| | <u>24.3</u> |

| <u>Operating Budgets (£)</u> | <u>Year 1</u> | <u>Year 2</u> |
|---|---------------|---------------|
| Weekly sales | 1,300 | 1,650 |
| Less purchase | 600 | 670 |
| | <u>700</u> | <u>980</u> |
| Weekly expenses: | | |
| Wages | 100 | 180 |
| Premises | 255 | 300 |
| Marketing | 80 | 80 |
| Vehicle | 60 | 70 |
| Miscellaneous | 26 | 26 |
| | <u>521</u> | <u>656</u> |
| Weekly profit before tax | 179 | 324 |
| Annual profit before tax, depreciation, drawings and interest | 9,300 | 16,800 |
| Annual sales All excluding VAT | 67,600 | 85,800 |

CASE B THE GARAGE DOOR COMPANY

The franchisor

1. Background

William Hamilton established the Garage Door Company Limited in 1978. He intended from the start to run a franchise system but waited until 1983 before signing the first franchisee. His pilot operation still runs in Edinburgh, employing 10 people, and providing the majority of his business revenue. The complete system has now grown to include four franchisees as well as the franchisor. It is fully based in Scotland. Although Mr. Hamilton once had very ambitious plans for expansion, it now seems likely that the network will remain small.

The franchisor is not a member of the British Franchise Association. There is no formally constituted franchisee association.

About two-thirds of the sales of a typical outlet are of new garage-door systems to private homes. The remainder are equally divided between subcontract work for builders and service work on existing installations. A franchisee would typically work from a small factory unit located on an industrial estate, operating one or two vans, and employing two people.

Mr. Hamilton expects his franchisees to specialise fully in garage doors and not to add technically complimentary lines like wardrobe doors to their businesses. He also expects there to be no additional business interests and for franchisees not to use limited-company status. Lately he has come to be against partnership status as well, due to difficulties with one franchisee. Franchisees are required to use Mr.

Hamilton's supply lines with all invoicing passing through his Edinburgh business.

There is much competition from door manufacturers, builders and other garage door companies.

2. Nature of the franchise

Garage Door offers a full business-format franchise with manuals covering all sales, service and administration procedures (the know-how). Financial assistance is not offered and neither are there specially provided packages from the banks, although Mr. Hamilton insists that banks have approached him with packages in mind. The franchisor is able to show his own Edinburgh operation as a model which can be easily duplicated elsewhere.

Mr. Hamilton sees the franchisee's obligations as duplicating the original model as closely as possible, buying doors and parts through his supply lines, and maintaining service quality. His own role requires him to monitor the system in accordance with the interests of the franchisor and all franchisees, to purchase products economically, and to provide central marketing support. He claims to find that franchisees have an expectation of him as if he were an employer.

A franchisee is essentially obliged to use the corporate image, operating methods and supply lines of the Garage Door Company. He then has the right to pursue business in the territory allocated to him. The territory is officially one in which the company will not set up another depot but is in practice treated as a sales area, and is based on Yellow-Pages areas. Franchisees bear all measurement and all bad-debt risks.

The franchise system of the Garage Door Company is illustrated in Figure B, where arrowheads show the direction of sales. There are no procurement links over which franchisees can exercise choice. The independent advertising agency which is shown is used by the franchisor to provide centralised marketing services. Strictly speaking the franchisee remains free to choose whether to supply any particular customer.

There are no highly specific assets created in the franchise as modest stocks are carried and equipment may easily be put to other uses.

3. Contract

3(i) The Agreement

The Franchise Agreement used by the Garage Door Company is an extremely detailed and comprehensive 20-page document running to almost 100 clauses. What follows is a much edited summary of the main clauses. A copy of the Agreement is available for inspection should this be required.

The first 25 clauses of the Agreement essentially define the franchise. It is "the method under the trade name" which is granted initially for five years but with an option to renew. The territory is one in which the franchisor will locate no additional depots although it may be noted that he leaves himself some discretion in this matter. If a franchisee's performance were "unsatisfactory" such location would be permissible. The franchisor will provide all necessary support at the launch of a franchisee, including advertising and training. Centralised advertising will be funded by a 4% levy on the franchisees' turnover (this has not been enforced at the time of writing). Equipment will be

provided at normal trade cost but supplies of garage doors and other parts will, in addition, incur handling charges. Telephone lines will be rented by the franchises but will be in the name of the franchisor, ensuring that business goodwill remains with the franchisor in the event of termination.

The franchisee will conform to the franchisor's methods and will not divulge these to any third party. There can be no employment of anyone who has been an employee of the franchisor or who has been a franchisee within the previous 12 months. There must be no other business on the premises and no involvement in a competitive business of any kind. The franchisee accepts tied-in sales from the franchisor. He also agrees not to appoint sub-agents. The franchisee's prices will be no higher than the manufacturer's or the franchisor's recommended retail price. Apart from these undertakings, the franchisee agrees to keep his premises business like, to encourage tidiness in his staff, and to allow the franchisor to vet his local advertising efforts.

The initial franchise fee is set at 2,500 and is meant to cover the franchisor's costs incurred in starting a franchisee in business. There is a weekly royalty of 5% on gross turnover excluding VAT. The franchisee agrees to cover any taxes imposed on the franchisor's fees of any kind and must pay interest of 2% per month on any late payment he might make. Each year, the franchisee must report audited revenues and costs to the franchisor.

The franchisee may sell his franchise with the consent of the franchisor and after paying a 2,000 fee. The fee is intended to cover the franchisor's costs incurred in starting up the transferee. In addition, 5% of the sale price is payable to the franchisor if he introduces a purchaser.

In the event of the death of the franchisee a simple transfer of the business to his beneficiary is possible. There is a three-month period for the beneficiary to decide whether to request this, during which the franchisor will provide a manager at cost. The beneficiary must be acceptable to the franchisor. Otherwise, or if the beneficiary wishes to sell anyway, the franchisor may exercise his option to buy back which is spelt out in the Agreement. If the beneficiary does not either take on the business or sell it, then the franchisor can repurchase it at its market value less 20%.

The grounds for termination of the Agreement by the franchisor are principally poor standards, insolvency, fee arrears, or information disclosure to a competitor on the part of the franchisee. Upon termination, the franchisee must return all trade-marked equipment and display materials and then cease carrying out the business. There is no scope for the franchisee to terminate the Agreement prematurely by giving notice.

One clause is very interesting as it gives the franchisor the right to impose a supervising manager on the franchisee if his turnover performance is not "substantial" within one year of the start of business. The clause leaves the franchisor considerable discretion even though there is some qualification over illness as a course for such action. One franchisee discussed below had this taken out of his Agreement.

Some clauses cover legal technicalities like servability, non-exercise not being a waiver of rights, no warranties without authority and the recognition that results are not guaranteed. There is also a professional limitation covenant which prevents an ex-franchisee from competing with the Garage Door Company for up to two years. Finally, compulsory binding arbitration is the

specified means for conflict resolution, with the Director of the British Franchise Institute or his nominee acting as arbiter.

3(ii) Implicit aspects of the contract

Mr. Hamilton claims that he has an aversion to unwritten business understandings and emphasises his attempts to make his Agreement as comprehensive as possible. Nevertheless, it is worth again noting that no advertising levy is in fact operated at the moment. Mr. Hamilton believes that his system is too small at present for this to be viable. He feels that his franchisees could not bear these payments. In addition, he experiences demands to behave in the manner of an employer, often giving detailed instruction to some franchisees to solve particular business problems.

The franchisor's handling charge for tied-in sales is mentioned but is not specified in the Agreement. This is an implicit aspect of the contract as the amount will be determined by what the franchisor thinks the franchisees can bear without jeopardising the long-term relationship. In principle, the tied-in sales could be used to extract economic rent from the franchisee.

3(iii) Enforcement and monitoring

The Agreement provides for weekly reporting by the franchisee of his revenue. This practice is strictly required, as also is the presentation of annual audited accounts. However, the franchisor does not observe the franchisee's daily conduct of his business as a matter of course. There are occasional visits from the franchisor's accountant, but these are aimed more at encouraging good housekeeping by the franchisee. The system of tied-in

sales anyway allows Mr. Hamilton to form a good impression of a franchisee's business costs.

Under-reporting of sales turnover is discouraged by the requirement for audited statements. Further control is exercised by the sales documentation system whereby a copy of all receipts goes to Mr Hamilton. Finally, customer complaints could indirectly alert the franchisor to a bootlegged sale.

Mr. Hamilton believes that his ultimate control over a franchisee stems from the possibility of terminating an agreement in the event of breach of contract. He does find it necessary to remind franchisees of their obligations from time to time. In one case which is discussed below (B₁) a warning was given of possible termination when the franchisee's partnership broke up and performance slackened. The warning led to the resolution of the problem.

The franchisor understands that he does have less formal mechanisms open to him for influencing franchisees. He realises that some of his supply lines are unique in the UK and knows that it would be hard for a franchisee to replace them. Thus a franchisee could be made to fear the loss of his supplies if he were to contemplate leaving the franchise system. At a more minor level, a franchisee in dispute with Mr. Hamilton could find his supplies slowed down, although this would probably mean reduced royalty payments.

According to Mr. Hamilton, no franchisees have had agreements terminated, none have left the system and no use has been made of compulsory arbitration. No manager has ever been imposed on a franchisee.

4. Why franchise?

Mr. Hamilton feels that the principal advantage for franchisees joining his system is the well-packaged brand image which he has invested in developing. Beyond this, he offers managerial support in all operating areas and believes that he provides a discipline to their activities which many franchisees would lack as independent businessmen. He does not aim to bear any risks for franchisees although he would claim that the risk of business failure is lower for them in the franchise system.

A number of advantages are claimed by the franchisor. First, he maintains control over sales and service in a way which would not be possible if ^{he} simply were to sell garage doors to any independent installer. He is therefore able to preserve a branded service which customers recognise as being of high quality. Secondly, he benefits from franchisee entrepreneurship and is convinced that this works to create much new business at the local level, especially when the market is poor. He also believes his own monitoring costs to be much lower than they would be in a non-franchised system using direct employees. Finally, he perceives capital-raising advantages to himself.

5. Fees and returns

It costs about £12,500 to set up a Garage Door Company franchise. Details of the outlays are given in Appendix B.

Apart from the 5% royalty, 2,500 initial fee and the possibility of a 4% advertising levy, all of which are discussed in section 3(i) above, the franchisor is currently adding a 5% handling charge to all tied-in

sales. Mr. Hamilton believes in setting sales targets and expects franchisees to show some growth on the previous year's sales. He is well satisfied with his profits and believes that franchisees make adequate returns. No sales figures of any kind were given to me. VAT is added to all fees charged by the franchisor and is claimed back by franchisees.

The franchisees

1. Franchisee B₁

B₁ has run the XXXX franchise on his own since 1985. For six months prior to then he was in a partnership which operated the franchise along with a double-glazing and house-insulation business. The work consists almost entirely of fitting domestic garage doors with some service work added. B₁ hopes to add subcontract work for local builders in the future. A fitter and his assistant are employed full time, along with a part-time secretary. The business operates from a factory unit in XXXX.

The franchisee sees his obligations mainly as maintaining the quality of fitting and minimising complaints, and building up sales. The franchisor is expected to give help and encouragement and to maintain quality within the system by monitoring all franchisees. B₁ believes that his and Mr. Hamilton's interests coincide and that this is the long-term basis of the franchise relationship. However, the franchisor does remind him of contractual clauses from time to time: "It rankles a bit, being told what to do when you are used to being self-employed". B₁ is the franchisee who was in dispute with Mr. Hamilton over inadequate performance caused by his partnership breaking up. Nevertheless, he was able to give an example of a recent minor disagreement which had been easily resolved by the franchisor. B₁ had threatened

to purchase a door from outside of the franchise system, as it had not been available from the franchisor. Mr. Hamilton made a great effort and diverted a door from his own operations in Edinburgh. It would seem that their relationship is now more settled.

B₁ believes that the brand name is very important to him. He thinks the well-designed company logo draws attention to a multibranch operation and that this attracts business. He also feels that the franchisor would help him if business conditions became tight and specified advice and payment rescheduling as the means by which this help would occur. In fact, the franchisor would maintain "strict accounting" in such times subject to the interest charge provisions in the agreement for any overdue fees.

In taking on his franchise, B₁ took advice from his bank and from an Edinburgh Consultant. Andrew James was the consultant and he had also been retained at an earlier stage by Mr. Hamilton at the launch of the franchise system. The basis of advice from both sources was that B₁'s previous working experience in the building industry suited him for garage-door installation work.

B₁ confirmed the structural details of the franchise system reported by Mr. Hamilton. He believes that the initial franchise fee was not sufficient to cover Mr. Hamilton's costs in starting him up. Also, B₁ believes that tied-in sales have a mark-up of about 5% although figures are not quoted to him. This estimate is based on his knowledge of trade prices and tallies with the handling charge which Mr. Hamilton quoted to me. As for sales targets, the franchisee is not aware of figures but believes that Mr. Hamilton has these (as indeed he does). B₁'s business has been through a bad patch, is just about

breaking even and is gradually picking up since the resolution of problems over the earlier partnership.

Although Mr. Hamilton does not like franchisees to have limited liability, he has reluctantly accepted this in B₁'s case. The earlier partnership had limited liability and B₁ has continued the practice in his new private company. My observations were of a small building business which was still very much in the start-up phase of its operations.

2. Franchisee B₂

B₂ is a skilled electrical technician. On returning from an overseas contract, he set up as a Garage Door Company franchisee in August 1986. He began as a job franchisee which meant that he paid a lower initial fee but a higher turnover royalty in exchange for a full administrative back-up from Edinburgh. However, from April 1987 he has been operating as a regular franchisee on the usual terms, using a factory unit in XXXX. The reason for starting as a job franchisee was that it limited his initial commitment.

A range of domestic, business and subcontract garage-door work is undertaken, along with some service work. B₂ employs his son as an assistant. All supplies are from Mr. Hamilton as specified in the Agreement.

B₂ feels his obligation is to preserve the quality-brand image that he believes to be attached to the Garage Door Company. He expects the franchisor to monitor the system "For the good of all" and to provide a full technical back-up. He knows of no cases of dispute within the system and has experienced plain sailing with Mr. Hamilton.

Again, it is the brand name which is the important advantage to the franchisee of belonging to the system. In addition, it should be noted that B₂ feels that he would be cut off from supplies if he tried to operate independently. Interestingly, he believes that no exact operating territory is marked out for him, which is not so as the franchisor has a precisely marked map.

B₂ confirmed the structural details of the franchise reported by Mr. Hamilton. Like B₁, he believes that there are no sales targets. However, B₂ is very happy with his early business returns and has been surprised to find "Such a good living in such a highly specialised business". My observations were of a busy small building business still very much at the start-up phase of its operations.

3. Franchisee B₂

B₂ was a civil engineer working on overseas contracts before opening as Mr. Hamilton's first franchisee in November 1983. The business operates from a factory unit in XXXX and employs four fitters, a salesman and a secretary. About two-thirds of all work consists of the sale and installation of domestic garage doors. The remainder is subcontract work for small builders and servicing. B₂ avoids working for big builders as he has found them to be bad payers (he is currently suing Barratts). XXXX is also covered from XXXX. The franchisor's wish for B₂ to open additional premises in XXXX is being resisted. All products are purchased from Mr. Hamilton, as specified in the Agreement.

B₂ sees his obligations as living up to the quality-brand image of the company and paying the royalty. He expects Mr. Hamilton to obtain products economically, to provide technical, commercial and legal support and to

monitor the franchise system in order to maintain the brand image. He believes that the franchisor is not as active as he could be in monitoring, citing the case of B₁ whose neighbouring franchise threatened to bring XXXX's work into disrepute when B₁ was experiencing his early difficulties. If anything, the franchisor "Bent too far backwards to retain a franchisee" in that case.

On the whole, B₃ enjoys a good relationship with Mr. Hamilton. He sits as a director on Mr. Hamilton's board. They often meet socially. The Agreement seems to B₃ to be "Very much filed in the drawer" and is not regularly quoted. The main advantage of being a franchisee is the ability to then use the brand name and logo. Again, it seems to the franchisee that he would lose access to certain door supplies if he went independent. Apart from the B₁ affair, B₃ is not aware of any disputes within the franchise system.

B₃ confirmed the structural details of the franchise system described by Mr. Hamilton. Interestingly, he is aware of sales targets set by the franchisor, no doubt due to his closer relationship. However, a clause in the Agreement was successfully resisted: this being the one giving Mr. Hamilton the right to install a paid manager if performance is unacceptable to him. The business showed losses for the first 18 months but is now giving a "reasonable profit".

A criticism of the system is that there are no direct links with suppliers. B₃ feels that whatever the implications would be for Mr. Hamilton's handling fee, direct links would save a lot of wasteful administration and time lags presently incurred as all orders pass through Edinburgh.

My observations were of a small budding company, which was beyond its start-up phase but which appeared to be not very busy.

Summary

Mr. Hamilton markets a branded service through a franchise system. This system has been slower to grow than he anticipated. Although there are some product lines which franchisees would find difficult to obtain, acceptable substitutes would not be impossible to find. At the end of the day, the franchisor may not be offering very much to prospective franchisees. Tied-in sales may give the franchisor a variable device for the extraction of economic rent, given that terms are not governed by the Agreement. Mr. Hamilton does occasionally refer to his Agreement with at least one franchisee, and has attempted (the impossible) to cover most eventualities in this document. Most of Mr. Hamilton's fees came from tied-in sales and a turnover royalty.

Franchisees recognise brand-name advantages to belonging to the system. They bear measurement and bad-debt risks. Except for B₂, no-one interviewed was impressed with current profitability. The Aberdeen franchisee was not interviewed.

An interesting feature of the franchise is the extent to which Mr. Hamilton has had to comply with franchisee's conditions before they would sign with him. B₂ wished to test the market before committing a large investment. B₁ retained limited liability against Mr. Hamilton's wishes. B₃ would not accept an Agreement clause allowing Mr. Hamilton to impose a manager if his franchise performed poorly. This feature supports by observation of a franchise system finding it difficult to recruit franchisees.

An extract from the franchise information pack is given as Appendix B. This is used to promote the franchise.

----- Subject to franchisee choice

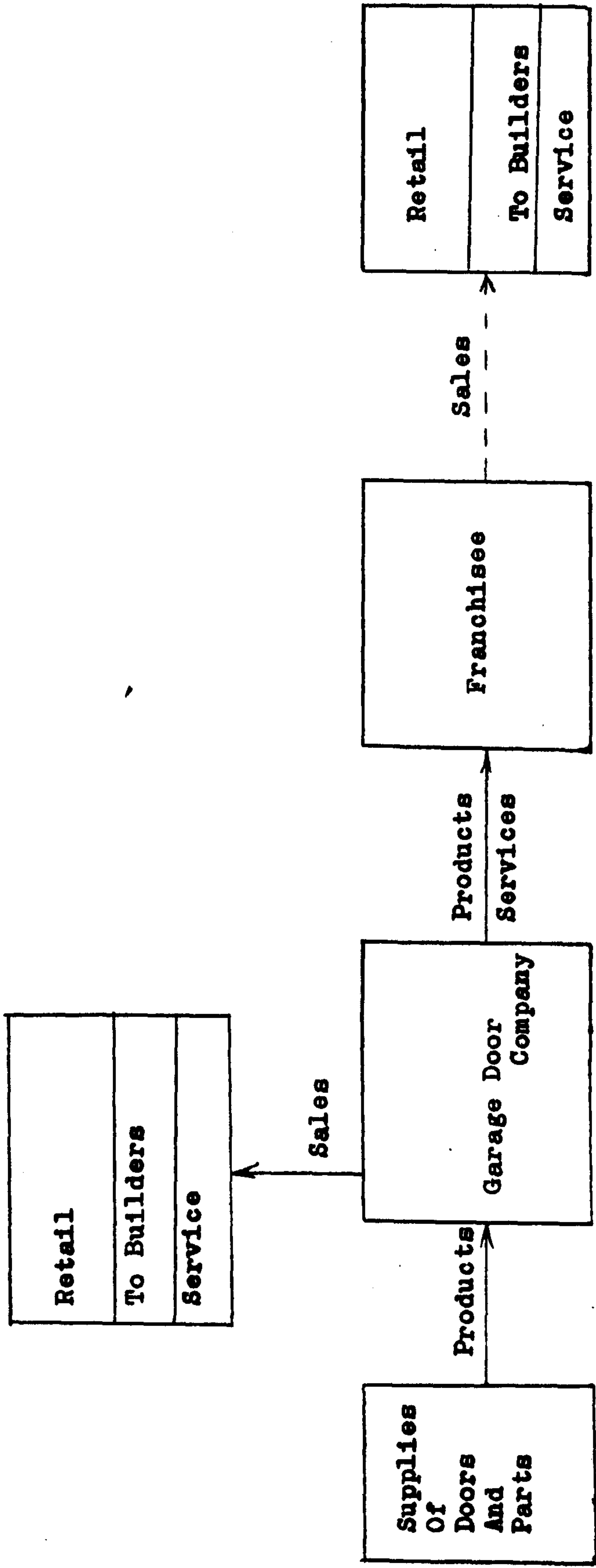


Figure B Garage Door Company Franchise System

- * Q. How much money will I require to invest?
A. A total of approx. £12,500.00. This varies according to location and type of premises available.
- * Q. What will I get for this sum?
A. This will cover your Franchise Fee, a fully-equipped van and trailer, starting stock, a small stock of spare parts, tools and office equipment (including desk, 2 chairs, filing cabinet, typewriter, carpet tiles and installed telephone).
- * Q. Can this initial investment be reduced in any way?
A. YES, if a) you already have the tools required,
b) your vehicle can be acquired through lease or H.P.,
c) you reduce your initial stock of doors.
In certain cases, the total investment can be as little as £4000.00!
- * Q. Would I be able to sell my franchise at any time?
A. Yes, whenever you wish, with our help.
- * Q. Can I speak to an established franchise before making my decision?
Yes, with absolutely no interference from us.
- * Q. How do I pay my Franchise Fee?
A. YOU DO NOT REQUIRE TO PAY A LUMP SUM IN ADVANCE! Instead, you pay as and when we supply the goods you need to get your business going.
- * Q. How do I pay for your continuing support?
A. You pay us a fee of 5% on your weekly gross sales.
- * Q. What is the most important factor in making a success of this franchise?
A. A business-like and enterprising approach, coupled with full co-operation with us to resolve any problems which may occur.

Appendix B Garage Door Company Promotional Material



UNIT 5
RUSSELL ROAD
INDUSTRIAL ESTATE
EDINBURGH
EH11 2NN
TEL: 031-337 3332

CASE C AVIS RENT-A-CAR LIMITED

The franchisor

1. Background

Avis is a world-wide operation which was initially established in 1946, in the USA, by Warren E. Avis who opened in Detroit with just three cars. Today it operates 3,500 locations in over 100 countries with an estimated fleet of 265,000 vehicles. Around 21,000 employees work in the international Avis system. Franchising was adopted early in the history of the US parent company.

Avis Rent-a-Car Limited was formed in 1965 to develop car rental in the UK. It did not adopt franchising until 1984. However expansion through franchised outlets has been rapid and there are now 53 of these as well as 70 company-owned rental stations (1987). Company outlets are located at airports and disproportionately in the south-east of England. Avis hopes to add 25 franchisees a year but intends to open no more directly owned outlets. In part this reflects the company's strategy of expansion into previously neglected local markets for car hire. According to data which Avis supplied for this study, in 1986, out of a total UK rental market worth £275 million, they had an 11.5% share. However, the share was more like 30% for national business rentals, and just 2.5% for local business and leisure use. Of the total market, about two-thirds is local hire business which is mostly covered by small, local firms. Avis has decided that it wishes to increase its penetration of local markets using locally based entrepreneurs as franchisees. Rental fleets consist of cars and light vans. About 75% of any outlet's fleet will comprise cars.

Avis's policy is to seek franchisees who will operate single-use sites under their logo. Some motor dealers do operate a franchise as part of a larger operation and some franchisees find that they can most easily rent a site which is part of a service station. Multiple franchises are not ruled out by Avis but the preference is for "owner-driver" franchisees, as this was expressed to me by Mr. Tony Brewer, the Franchise Development Manager. He prefers to have franchisees with just one to five outlets, rather than have whole areas of the country tied up by one franchisee. The fear is that a large multiple franchisee would lost touch with his local market place.

Avis belongs to the British Franchise Association. There is a franchisee association.

2. Nature of the franchise

Avis offers a full business-format franchise with manuals covering all operating, sales and administrative procedures. A computerised administrative system (Wizard) which links with centralised Avis reservations, is also available. No financial assistance is given to franchisees and Avis in fact regards their independent ability to raise finance as an important part of the selection procedure. A finance scheme specially tailored to Avis franchisees has been developed by the National Westminster Bank. Franchisees are directed to this. Avis can show its owned outlets as working models for franchisees.

Mr. Brewer sees franchisees' obligations as honouring the franchise agreement and maintaining service levels at least equal to those of the company-owned stations. In turn, he sees Avis as providing technical and product innovation, giving marketing support, and using purchasing

expertise to obtain good fleet and insurance deals for franchisees.

A franchisee essentially receives the rights to operate under the Avis brand name, to use centralised booking arrangements, and to participate in a system of one-way vehicle hire. The Avis franchise is illustrated in Figure C, where dotted lines are used to show trading links over which franchisees have free choice, and where arrowheads show the direction of sales. No product is sold by Avis. Franchisees may choose to use company supply lines to lease or to purchase vehicles from manufacturers, and in particular from the Ford Motor Company. The lease arrangements are particularly attractive with manufacturers being very keen to place their cars into hire fleets as a promotional device. The cars are leased for 9,000 miles or six months, whichever is the sooner. The boxes showing the rental market in Figure C show the division of internationally and nationally generated rentals into business and leisure hirers in the approximate proportions in which these arise. In addition, the franchisees are shown to be more involved in local as opposed to international business. Strictly speaking, the franchisee is not free to choose whether to service any particular customer, as he must accept centrally booked and nationally negotiated hires and must service cars rented on the one-way systems.

There are no stocks of products specific to Avis nor are there any investments to be made by franchisees in specialised equipment. Avis uniforms and display items are provided by the company. Franchisees could adapt their premises to other uses reasonably easily, although not costlessly. Set-up costs are around 25,000 for the franchisee, excluding franchise fees. Around 10,000 of these are sunk costs.

3. Contract

3(i) The Agreement

Avis uses a standard Franchise Agreement with its franchisees. Since Avis Rent-a-Car Limited is the licensee of Avis Incorporated of the USA, it describes itself as the licensor, its franchises as licensees, and its Franchise Agreement as a Sub-Licence Agreement in its formal, written contracting. There follows a simplified outline of the principal clauses of the Agreement. The franchisor/franchisee terminology will continue to be used. A copy of the Agreement is available for inspection should this be required.

The Agreement begins by defining the sub-licence arrangement between Avis Incorporated and the franchisee, through Avis Rent-a-Car Limited. The franchised system is defined as the uniform marketing and operating methods of Avis. The Agreement then sets the franchise fee, the area which is franchised and the five-year term of the Agreement. Separate schedules are added to specify the fee and area. The franchisee accepts Avis's right to modify the system and undertakes to fit in.

The franchisee agrees to provide insurance on vehicles and drivers, to use Avis's rental agreement, to work in a business-like manner from procedure manuals, to allow Avis the opportunity to inspect the business, and to honour all credit cards approved within the Avis network. In addition, a number of financial terms are set. Turnover on rentals must be reported monthly to Avis along with customers' payments for personal accident insurance. A 10% royalty is due each month on turnover, where this consists of vehicle time and mileage charges plus collision-damage-waiver fees. A 40% royalty is due on charges for personal accident insurance. Overdue

franchise payments will attract interest at 5% above Midland Bank Plc annual base rate. Hire rates used by the franchisee must be reported to Avis but there is no attempt at retail price maintenance. Also, the franchisee undertakes to fit in with Avis over advertising: 2.5% of time and mileage charges are to be spent on local advertising, and standardised Yellow-Pages and telephone-directory entries must be placed by the franchisee. Further undertakings are that the franchisee will ass on business to other territories if this is appropriate and that he will participate in Avis's one-way rental system.

Finally, the franchisee agrees to use the Wizard computerised system if Avis insists on this.

Avis agrees to grant the use of the Avis name to franchisees, to provide corporate-image displays and stationery, to give vehicle procurement help, to be available for consultation, and to issue directories of outlets.

Vehicle fleet details for a particular franchisee, and the plan for the growth of this, are set out using an attached schedule. Also given are details of rental sharing which may arise over the operation of the one-way system. The franchisee agrees to participate in this system, under which vehicles may be left at an outlet from which they did not originate and may then be used by the receiving station, preferably as a means to make a return journey. The renting company (Avis or a franchisee) must pay 60% of time and mileage charges to the owning company. The franchisee undertakes to service vehicles presented to him by customers for this purpose, even if they are not his own.

The franchisee may terminate the Agreement by giving six months' notice of his intention to do so. The

franchisor's grounds for termination cover breach of any contractual term by the franchisee, the latter's insolvency and any case of substandard operation. Also, the franchisor may give notice that a renewal option attached to the term of the Agreement is not to apply. Finally, legislative changes which jeopardise the franchisor's returns would be grounds for termination.

There are a number of important but largely technical sections. Failure of the franchisor to exercise a right does not constitute its waiver. All rights to trade marks and the system revert to Avis on termination. Owners and managers of the franchised outlet are subject to Avis's approval before they can take up ownership or be appointed. Transfer of the franchise is possible with Avis's consent and, in addition, it can be inherited by a franchisee's beneficiaries. Finally, very technically, the franchisee is not to be regarded in law as the franchisor's agent and the Agreement is to be regarded as the whole contract.

Avis uses a fairly minimal Agreement which, despite some clauses, does not really try to cover every eventuality.

3(ii) Implicit aspects of the contract

Mr. Brewer believes that there are three important business understandings between Avis and its franchisees. I interpret these to be implicit contractual terms in that they are nowhere written down yet they are important parts of the relationship between franchisee and franchisor. They are governed by the long-run value of the franchise relationship. First, there is an expectation that the franchisor will undertake a significant amount of national advertising, although technically this is at the franchisor's discretion. In the 1986/87 financial year,

£0.5 million was spent. The figure was reached by Avis using a task and method approach, where expenditure is set to meet certain advertising objectives (for example television exposure to be equal to that of rivals). The feeling at Avis is that large expenditures are required as part of a means of keeping good franchisees in the network.

Secondly, there is an expectation held by the franchisor that franchisees will operate vehicles meeting Avis quality standards. This is the "no-Ladas principle", as Mr. Brewer put it, referring to the exclusion of cheap, low-quality, East-European cars from the business on this criterion. Whilst the maintenance of standards is emphasised in the Agreement, a particular detail of this kind is not spelt out and relies on a subsequent informal understanding.

Thirdly, Avis has an understanding that franchisees will pay their own travel and subsistence costs incurred when attending training sessions. This is not specified in the contract but is accepted by franchisees rather than risk disrupting good relations with Avis, who pay all other training costs.

There is no expectation that franchisees will lease property through Avis. They are free to make any arrangements which suit them.

An interview with Mr. Michael Turner, Scottish District Manager for Avis, revealed a further understanding. Mr. Turner believes that it is accepted that Avis will take part in the selection of a franchisee's personnel. This is a strong addition to the control over management appointments, which relates only to the Managing Director and Operations Manager, listed in Section 11 of the Agreement. Normally this involvement in

selection arises when Avis offers the assistance of its Personnel Department to the franchisee.

Mr. Turner confirmed the existence of the no-Ladas principle. He also revealed that it is understood that Avis vehicles may be used by a new franchisee at uncontrolled local rates until his business begins to be established. Then they may be used only at national, Avis rates. This represents a little initial support for the franchisee and will be applied in a discretionary manner by Avis's regional managers. Franchisees confirmed the existence of this initial help.

In fact, the understanding over using corporate vehicles embodies a further understanding over pricing: normally, Avis-owned vehicles will be rented at Avis's corporate-outlet rates. The Agreement has nothing on this, and disclaims any attempts at price maintenance. Furthermore, the remainder of this understanding is that, other than for Avis-owned vehicles, the one-way rental system will operate on local rates which franchisees are free to set subject to giving 30-days notification to the franchisor. The notice requirement prevents a franchisee from using the vehicles of others at knock-down rates. It is also true that nationally negotiated company accounts must be serviced by franchisees at the negotiated rates.

3(iii) Enforcement and monitoring

Monitoring of the franchise network is fully integrated with that of company outlets. Daily conduct of the business is observed by District Managers, on average about once a month in the case of franchisees. Apart from the requirement in the Agreement for monthly performance reporting, copies of each day's rental agreements are sent into a franchisee's district office. For the first three

months of operations copies also go to the head office in Staines.

Mr. Brewer feels that the Agreement should not be continually quoted at franchisees but, rather, exists as a last resort to clarify issues in a business relationship. He would feel that his franchise department would be failing in its work if franchisees ever had to report one another over substandard operation. Mr. Brewer claims that there are a few minor disagreements within the network over things like servicing transferred vehicles. Otherwise it is dispute free. There have been no terminations, contractual breaches or voluntary exists. In this last respect, it is important to note that the Avis Agreement makes it easy for a franchisee to leave after giving 6-months notice of his intention.

The monitoring system is reinforced by the possibility of centralised complaints indirectly alerting Avis to under-reported rentals. Also, Avis claims to have a good idea of what business an outlet should produce. Underachievement would lead to investigation so that, again, honest reporting is encouraged.

Mr. Brewer describes monitoring costs as very low for the franchised network relative to company outlets as so much daily supervision can be left to the franchisee.

4. Why franchise?

Mr. Brewer believes that Avis offers an huge brand name advantage a franchisees: "It is what we are selling". In addition, central reservations and a national sales team which is active in the pursuit of company accounts both generate rental business for franchisees. The vehicle and insurance supply lines are also an advantage which Avis has to offer. Finally, the operating system

used is held to keep costs to a minimum, which helps franchisees to weather better any demand recessions.

Avis gains largely from an influx of entrepreneurial talent at the local level. Mr. Brewer told me "We will not just take on investors, as we need entrepreneurial participation". The company's wish to expand into local markets requires that branches make efforts to drum up local business, for example going out to local businessmen to establish new accounts. It is felt that this is most likely to happen when a branch is run by a financially committed franchisee. In addition, Mr. Brewer can point to customer letters reporting higher service standards among franchisees compared with Avis-owned outlets. Finally, capital-raising advantages are perceived.

5. Fees and returns

The Agreement allows for a 10% royalty which is levied on turnover excluding VAT. In addition, the current lump-sum initial franchise fee stands at £15,000 in 1987. This figure is negotiable for a franchisee with an established rental site. The negotiation occurs for two reasons. First, Avis is keen to move its logo into established sites as a matter of business strategy. Secondly, Avis's costs in starting up a franchisee are lower for an existing business. The start-up package includes such things as help with shopfitting, provision of uniforms, launch advertising, three-months stationery requirements, training, and promotional materials. Avis does not aim to make a profit from the initial fee. VAT is added to all fees paid to the franchisor and is claimed back by the franchisee.

Full set-up costs for a franchisee are in the region of 25,000. An example, of an Avis-supplied profit and loss projection, as an hypothetical fleet is built up to

26 cars and nine vans, is given as Appendix C. The franchisee's income as a manager is included in costs. Fairly healthy operating profits are shown from the first year of operation. No longer-term projections are available. It should be remembered that fleets are expected to build up to higher levels in subsequent years (one franchisee discussed below has 75 cars and 25 vans). Also, capital costs do not feature in the appended projection.

Sales targets are not set as such but fleet projections do form part of the Agreement. Mr. Brewer believes that franchisees show better returns than would be common in the vehicle rental business. Avis is very happy with its profits which increased by about 350% between 1984 and 1987.

The franchisees

Franchisee C₁

C₁ began as an Avis franchisee in 1986, with a fleet of 18 cars and three vans having been previously employed by XXXX XXXX. His rental work comprises locally, nationally, and internationally generated business in equal proportions. As a franchisee he has gained relatively more local business compared with the performance of Avis's company stations. The franchise operates from the XXXX XXXX Service Station, XXXX, where C₁ also has an XXXX petrol-retailing dealership. He employs three people. One-half of all vehicles are leased and the rest are bought through Avis lines from Ford.

C₁ sees his obligations as maintaining Avis's quality-brand image in XXXX and paying his royalty. His expectations of the franchisor are that an efficient central reservation system should operate and that the

brand name should continue to be well recognised by the public. The reservation system generates about one-half of his business as XXXX is a tourist centre.

For the first six months of operations, an understanding existed that Avis-owned vans arriving at XXXX could be used locally to help build up the business (with 60% of the rental being remitted to Avis). This has now tended to encourage C₁ to add to his van stock. C₁ does not experience regular reference to the Agreement by senior Avis personnel. He does however find that managers of outlets which are owned by Avis occasionally cite it when asking him to recover vehicles which have broken down in his area. This annoys him although he is paid for any service work which he does.

C₁ feels that the Avis brand name is of considerable value to him. This, together with the possibility of participating in the one-way rental system, led him to sign with Avis rather than operate independently. He also sees advantages flowing from the central reservation system which Avis operates. Company supply lines for insurance and vehicles are less highly valued than Avis may believe. C₁ thinks he could do quite well on his own in these areas. He would not have any wish to lower the quality of vehicle which he uses.

C₁ confirmed the structural details of the franchise system which Avis described. He in fact paid only a £12,000 franchise fee as his was an existing site in the sense that some office accommodation was available on the petrol station. His agreed fleet targets mean that he should have 30 cars and eight vans by 1991. He is happy with his profitability and intends to stay with Avis.

However, C₁ has had a dispute with Avis over vehicle-recovery charges incurred over use of the one-way rental



system. He complains that Avis are very quick to charge him for recovery of his vehicles, when he wishes them to be sent back to him even though no rental is possible for the return journey, but that they are slow to pay him for recovering their vehicles. This issue remains unresolved but recently C₁ has threatened not to recover vehicles unless payments are speeded up.

My observations were of a busy local rental station. The Avis identity is not lost even though siting is on a petrol station.

Franchisee C₂

C₂ trades as XXXX XXXX and was already established as a commercial vehicle hire company when he signed with Avis. He became the first franchisee in early 1985, and joined as a means of expanding into car hire. The fleet now consists of 75 cars and 25 vans, and 20 heavy trucks which are still hired out under the XXXX logo. Avis is not involved in the heavy end of the market. There are also petrol-station and servicing components to the XXXX business on the XXXX site. My observations were of a busy local car-rental business which looks like a service station incorporating an Avis office and fleet.

Around 20% of all rentals are to private users and the rest are to businessmen. 10% of rentals are generated by central reservations with the remainder of the business being mostly locally generated, coming particularly from the XXXX XXXX XXXX. XXXX fits in well with Avis's wish to expand into local markets using local entrepreneurs.

Almost all vehicles are leased from Ford through Avis channels. A manager, his assistant and three service agents (who prepare vehicles for hire) are employed

C₂ believes that his main obligation is to maintain the quality of service on which Avis's reputation is based. He expects the franchisor, in turn, to promote this quality-brand image. He also expects the centralised booking and one-way rental systems to operate efficiently, and for good supply lines to be established for vehicles and insurance.

The contract is not regularly quoted by Avis, in C₂'s experience, but reference to it was made recently when XXXX's shareholders changed. The understanding limiting the fleet to quality vehicles ("no Ladas") is also recognised by him.

Avis's brand name is the major advantage of being in the system. C₂ also mentioned the one-way system and service support for international rentals as being important benefits. In general, he feels himself to be in a stronger position through his association with Avis.

C₂ reports that there are minor disputes within the franchise network. He feels that central reservations are not always passed to franchisees when they should be but may find their way to nearby company outlets. He has had petty gripes over territorial observance with local company stations. His judgement is that systems need improving in the long run.

C₂ confirmed the structural details of the franchise system. In the case of XXXX, a franchise fee of only 8,000 was required as it was an established business. Profitability has improved since xxxx joined Avis. Minimum-fleet targets are already being exceeded.

Franchisee C,

C, began as an Avis franchisee in late 1985, having previously worked in engineering management. He operates from a site rented from the XXXX XXXX Service Station, XXXX, with a fleet of 31 cars and four vans. He employs an assistant, a full-time service agent and five part-time helpers.

Around 90% of all rentals are to business users. Only 5% of all business arises from central booking with the rest being mostly generated locally. XXXX fits the Avis plan of expansion into local markets.

C, believes his obligation is principally to uphold Avis service standards. He expects the franchisor to give general support, to help to attract business through advertising, to promote the brand, and to police standards throughout the network.

There is no regular reference to the Agreement in the case of XXXX. C, confirms the existence of an understanding that there should not be excessive use of Avis-owned vehicles outside of the initial start-up period. In general, the franchise system seems trouble free as a recent franchisee conference suggested no real problems. C, experiences occasional uneasiness over his relationship with company outlets. He finds it hard to be precise about this but senses that the franchise system "Threatens the future of middle managers".

C, believes that the brand name of Avis is of great value to him but points out that it can sometimes be a problem. Customers perceive a quality brand which they believe will prove expensive. Competition is often on price in local markets. The one-way rental system is also seen as an important benefit. Also, because Avis-owned

cars can be used, the one-way system runs better for franchisees than one operated by Budget Rent-a-Car (which relies entirely on franchisees' own cars as Budget is a wholly franchised operation).

C₃'s franchise has a standard structure. He paid a £15,000 initial fee and had his accountant check that at least this amount was spent by Avis at the start-up. This proved to be the case. The fee included the provision of a prefabricated office. No profits had yet been made when I spoke with C₃ in June 1987. He anticipates these for the following financial year.

An unexpected point arose during this interview. C₃ has carefully chosen to lease his site from the filling station on very short terms. The leases are for three months at a time. He justifies this by his wish to limit his commitment to the business in case profits do not materialise. My observations were of a locally based business which was still very much at its start-up stage.

Company outlets

Avis runs only company outlets in Scotland. I interviewed Michael Turner, Scottish District Manager, to ascertain some of the differences existing between franchised and company outlets and to obtain comments on some of the conflicts described by franchisees. Some of Mr. Turner's information is summarised earlier in this case (3(ii) above).

Mr. Turner reports that controlling company outlets is a straightforward matter of enforcing company policy. There are no difficulties caused by the independence of a franchisee. However, many day-to-day decisions require district management to be involved in a company outlet whereas they would just be left to the franchisee. He

believes that monitoring is more costly on balance for company outlets. Regional management structures are more occupied by matters relating to company stations.

Mr. Turner believes that all outlets will try to use the one-way rental system to shift costs. Franchisees will worry about their profits whereas company managers are on profit-related bonus schemes. The specific problems encountered by C₁ are most likely due to changing vehicles which break down in his area. If he replaces a vehicle he only receives the 60% hire fee that he would receive if his vehicle had been hired out of its own area. This may be resented as the opportunity cost could be the full local rates.

I observed the company's station in Edinburgh and saw no superficial differences compared with franchised outlets.

Summary

The Avis franchise offers a brand name and a national rental network to franchisees. Avis is able to draw on local entrepreneurship to develop local business by franchising. It appears that there is no attempt by Avis to make profits from lump-sum franchise fees. Avis's returns come from a royalty which is levied on rental turnover. The single-use site does not materialise among franchisees. All of those whom I interviewed had set up on service stations, and this appears to be efficient. Some problems exist over fitting the franchised outlets in with the company stations. Some of these could no doubt be cured by altering payment schedules (for example, replacement vehicles could be charged at full local rates).

The franchisor may use the initial franchise fee and the royalty to extract any economic rent arising for franchisees. There are no tied-in sales and no control of leases. The royalty is set in the Agreement. Avis has no means of responding to unforeseen changes in retail profitability. It is noteworthy that franchisees may give notice to quit and could move to other suppliers of franchise services. It is also interesting that initial fees vary from site to site suggesting the value of Avis's services also varies across markets, or that set-up costs vary.

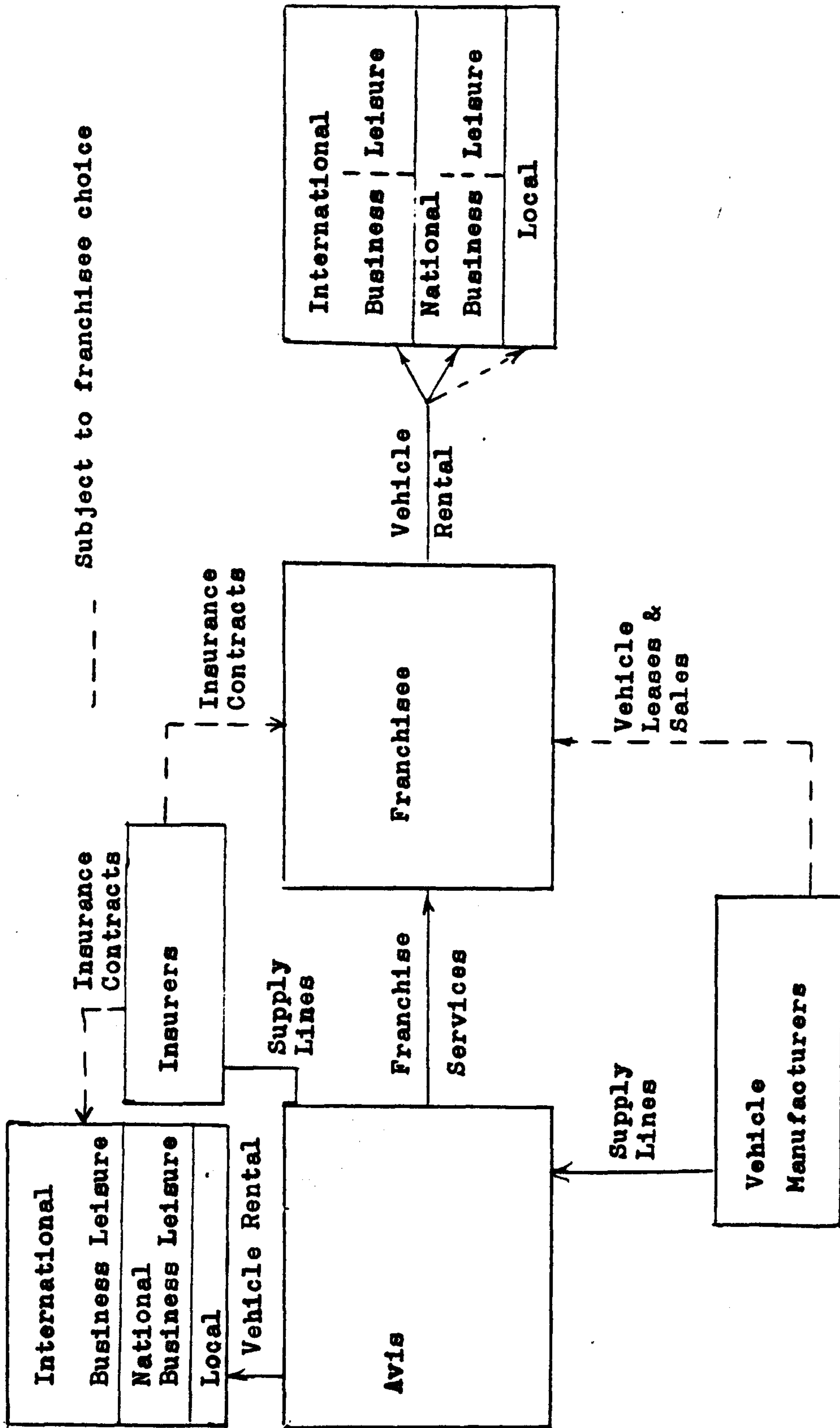


Figure C Avis Franchise System

Appendix C Avis Profit and Loss Projection

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| Month | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | TOTAL | % |
|--------------------------|--------|--------|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|-----|
| <u>REVENUE</u> | | | | | | | | | | | | | | |
| CARS | 3176 | 3812 | 4955 | 5368 | 6670 | 7115 | 8004 | 9338 | 10482 | 11435 | 11911 | 12387 | 94652 | 73 |
| VANS | 1052 | 1157 | 1690 | 2107 | 2282 | 2746 | 3198 | 3198 | 3943 | 4429 | 4429 | 4429 | 34659 | 27 |
| TOTAL | 4228 | 4968 | 6645 | 7475 | 8953 | 9861 | 11202 | 12536 | 14425 | 15864 | 16340 | 16816 | 129312 | 100 |
| <u>VEHICLE VARIABLES</u> | | | | | | | | | | | | | | |
| MAINTENANCE | 190 | 190 | 233 | 262 | 292 | 321 | 365 | 408 | 437 | 481 | 496 | 510 | 4185 | 3 |
| INSURANCE | 416 | 489 | 654 | 736 | 881 | 971 | 1103 | 1234 | 1420 | 1562 | 1609 | 1656 | 12733 | 10 |
| LEASING CHARGES | 2154 | 2154 | 2766 | 3056 | 3390 | 3758 | 4292 | 4730 | 5211 | 5831 | 6035 | 6322 | 49699 | 38 |
| ROAD TAX | 108 | 108 | 133 | 150 | 167 | 183 | 208 | 233 | 250 | 275 | 283 | 292 | 2392 | 2 |
| TOTAL | 2868 | 2941 | 3786 | 4205 | 4730 | 5234 | 5968 | 6606 | 7319 | 8150 | 8423 | 8780 | 69009 | 53 |
| <u>REVENUE VARIABLES</u> | | | | | | | | | | | | | | |
| FUEL MARGIN | (54) | (64) | (85) | (97) | (115) | (128) | (146) | (161) | (187) | (206) | (211) | (217) | (1672) | (1) |
| PAI COST | 67 | 79 | 105 | 117 | 141 | 155 | 175 | 198 | 227 | 249 | 257 | 265 | 2035 | 2 |
| CLEANING | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 480 | 0 |
| CHARGE CARD FEES | 106 | 125 | 167 | 188 | 225 | 248 | 282 | 315 | 363 | 399 | 411 | 423 | 3251 | 3 |
| COMMISSIONS | 36 | 43 | 57 | 64 | 77 | 84 | 96 | 107 | 124 | 136 | 140 | 144 | 1108 | 1 |
| ADVERTISING | 91 | 106 | 142 | 160 | 192 | 211 | 240 | 268 | 309 | 340 | 350 | 360 | 2769 | 2 |
| LICENCE FEE | 406 | 477 | 638 | 718 | 860 | 947 | 1076 | 1204 | 1386 | 1524 | 1570 | 1615 | 12422 | 10 |
| DOUBTFUL ACCOUNTS | 14 | 17 | 23 | 26 | 31 | 34 | 38 | 43 | 49 | 54 | 56 | 58 | 443 | 0 |
| TOTAL | 706 | 823 | 1087 | 1216 | 1450 | 1592 | 1802 | 2014 | 2310 | 2536 | 2612 | 2688 | 20837 | 16 |
| <u>FIXED COSTS</u> | | | | | | | | | | | | | | |
| SALARIES | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 1944 | 23328 | 18 |
| RENT | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 625 | 7500 | 6 |
| RATES | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 167 | 2000 | 2 |
| COMMUNICATIONS | 18 | 24 | 39 | 45 | 54 | 61 | 70 | 70 | 72 | 86 | 85 | 88 | 712 | 1 |
| GEN & ADMIN | 18 | 24 | 39 | 45 | 54 | 61 | 70 | 70 | 72 | 86 | 85 | 88 | 712 | 1 |
| LIGHT, HEAT & POWER | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 600 | 0 |
| TOTAL | 2822 | 2834 | 2864 | 2876 | 2894 | 2908 | 2926 | 2926 | 2930 | 2958 | 2956 | 2962 | 34852 | 27 |
| PROFIT/(LOSS) | (2168) | (1630) | (1092) | (822) | (121) | 128 | 506 | 990 | 1866 | 2220 | 2349 | 2387 | 4614 | 4 |

CASE D MOBILETUNING LIMITED**The franchisor****1. Background**

Mr. Anton Rowntree established Mobiletuning Limited as a franchise system in 1976, in partnership with Mr. Derek Morley. Both had begun separate mobile car-tuning businesses in 1973 and subsequently became partners. The system has now grown to include 65 franchisees each on annual sales turnover of about £30,000. Mobiletuning competes with firms like Hometune for the market for tuning cars and light commercial vehicles at customer's homes or workplaces. A typical customer would be a private motorist who runs a five-year-old car.

Mobiletuning prefers franchisees to operate just one tuning van. There are no cases of multiple franchises. A typical franchisee is a man with mechanical aptitude who operates a Crypton engine-tuning apparatus from a van. He is often assisted in his booking system and in keeping accounts by other members of his family. Mr. Rowntree arranges training for a franchisee and the equipping of the van and supplies ignition and other components if these are required. Although Mobiletuning is a main distributor for NGK, a Japanese manufacturer of spark plugs, there are no tied-in sales.

The company belongs to the British Franchise Association. There is an association for franchisees.

2. Nature of the franchise

Mobiletuning offers a full business-format franchise with manuals covering all aspects of operations, marketing and administration. Many franchisees come from

backgrounds different from the motor trade and really start from scratch. Tuning procedures are rigorously standardised as is the sales-recording system. The use of company manuals is more discretionary outside of these areas for a franchisee. Essentially a franchisee has the right to trade under the Mobiletuning name using the know-how summarised in the manuals. He may choose to purchase supplies from the company. The system is illustrated in Figure D, where arrowheads show the direction of sales.

Mr. Rowntree considers that franchisees have one real obligation which is to represent the brand name well by maintaining high standards of service. He sees Mobiletuning's role as ensuring that the business is profitable by developing brand awareness among customers, procuring good quality supplies at reasonable prices, and maintaining up-to-date technical procedures. In addition, he emphasises a role as system monitor. I was told that "Poor-quality franchisees would cause us all to suffer a loss of business".

Mobiletuning only operates one company-owned van. This is in Greenwich where the company has its base. The van is run purely as a device to keep the franchisor informed about current operating costs and conditions. It is only rarely used as a model to show prospective franchisees, who are generally happy to join following conversations with randomly chosen existing franchisees.

Financial assistance is not provided for franchisees by Mobiletuning. The company is happy to advise on sources of finance.

There is very little investment in specialised equipment or stocks. The van and tuning equipment could easily be sold without excessive loss or could be used outside of the Mobiletuning network.

3. Contract

3(i) The Agreement

Mobiletuning uses a Franchise Agreement which has been kept as simple and as brief as possible. Mr. Rowntree believes it acts principally to protect franchisees by letting them know where they stand. Its principal clauses are now simply summarised. A copy of the Agreement is available for inspection should this be required.

The Agreement first sets the franchise fee and grants the franchisee the right to operate as Mobiletuning in an area which is specified by postcodes. The operation must begin within two years of signing the Agreement.

The franchisee undertakes to promote the business in his area, to operate in a business-like manner, not to operate extra unauthorised services under the brand name, to allow Mobiletuning to vet any employee prior to their appointment. Furthermore, he will not charge less than Mobiletuning's recommended prices without prior approval, and will pay the royalty and submit copies of all charge sheets. If the Agreement is terminated, the franchisee will not compete with Mobiletuning in his area for two years. Interestingly, the franchisee agrees to pay a minimum royalty based on tuning 40 cars each month. The franchisee agrees not to damage the interests of the franchisor or other franchisees. Strictly speaking, the franchisee remains free to choose whether or not to service any particular customer.

The franchise may be sold and transferred with the franchisor's consent. It may also be inherited by the franchisee's beneficiaries in the event of his death. The 10-year term may be extended by mutual consent for

additional 10-year periods with no further lump-sum franchise fee.

The franchisor's undertakings are mostly of a general kind. He will assist the franchisee to run his business profitably, provide initial and continuing training especially in technical matters, supply free tuning sheets detailing work done and acting as receipts for customers, and procure products at economical prices. In addition, Mobiletuning will build the brand name and give promotional support, including the provision of a local Yellow-Pages advertisement for each franchisee.

The franchisee has the right to terminate the agreement by giving three-months notice. The franchisor may terminate for any breach, or in the event of the franchisee's insolvency.

Failure to enforce any right is not to be taken to indicate its waiver by the franchisor. Finally, the Agreement is described as embodying the entire contract between the parties. There is only a small number of purely technical clauses, and no provision for compulsory arbitration. No rate of interest is specified for overdue franchise fees.

3(ii) Implicit aspects of the contract

Two implicit aspects of the contract between franchisor and franchisee emerged from the interview with Mr. Rowntree. First, there is a strong expectation that Mobiletuning will pay the costs of all training excluding travel and subsistence costs for franchisees. This has led in recent years to the Directors or a Training Officer visiting a region from time to time on the grounds that this less costly for franchisees. Rather than visit individuals, Mobiletuning uses one as a base to which all

neighbouring franchisees come for a training session. The full understanding which has arisen is that direct training costs will be borne by the franchisor and, in addition, training will be organised to minimise attendance costs to the franchisee including his time lost from operating the business. Keeping the franchisee engaged in operations as far as possible benefits the franchisor through his royalty. Training is an important element of the franchise package as current vehicle specifications are subject to much change.

A second implicit aspect is that franchisees are free to offer some non-tuning services. Some undertake general servicing lubrication services, vehicle alarm fittings or automatic choke conversion work. These extras can help a franchise to set up profitably, especially in areas of low population. Even though the Agreement largely rules out subsidiary services, there are cases where the franchisor ignores the use of Mobiletuning receipts for these purposes because he realises that extra revenue helps to keep a franchisee in business.

3(iii) Enforcement and monitoring

Mr. Rowntree does not believe that the Agreement exists to be regularly quoted. He told me that Mobiletuning always tried to avoid litigation: "If it came to that we would not want each other anyway and would no doubt part company by some arrangement". Rather, he feels that the long-term value of the franchise relationship will always enable disagreements to be resolved.

All sales receipts must be submitted to the franchisor on a monthly basis according to the Agreement. There is a three-copy system in which the customer, the franchisee and Mobiletuning each receive a copy of the receipt, which also details the work completed and acts as

an invoice. Apart from the possibility that centrally received customer complaints or comments could alert the franchisor to sales discrepancies, and his occasional observation of franchisees, there is no real check on honest reporting of sales. Mobiletuning runs a van in Greenwich and has some idea of the amount of business which is possible, but regional differences will exist. No tied-in sales exist to act as a check. Mr. Rowntree believes that his franchisees are fairly honest in revealing their sales for royalty payment purposes, and does not believe that additional monitoring would be cost effective. A voluntary system exists whereby franchisees submit details of their costs and in which 50% participate.

Mr. Rowntree described his monitoring system as justified by its low cost. Only three employees work at head office. This figure is impressive, bearing in mind that there are 63 franchisees throughout England and Wales and a further two in Scotland. He told me that "It is just not worth checking a little bit of work done on the side". His methods place a lot of emphasis on selecting only those who he feels to be trustworthy as franchisees.

In the 10 years for which the franchise system has been operating, there have been few disputes according to Mr. Rowntree. The Agreements of two franchisees have been terminated because of their inability to generate sufficient business. 10 franchisees have left the system but for innocent reasons: for example, one enjoyed a win on the football pools. The franchisor has tightened up his selection process in order to avoid the adverse selection experienced in the two terminations. Mr. Rowntree believes that a franchisor's image is badly damaged by cases of termination.

There is a franchisee association which meets each year.

4. Why franchise?

Mr. Rowntree believes that Mobiletuning has a lot to offer franchisees. The brand name is important and it is much easier to recruit franchisees now that it is established. Also, Mobiletuning can give a lot of marketing support in terms of promotional material and methods. On his own a franchisee would "Compete on price alone and lose money". However, the point which Mr. Rowntree emphasises is the up-to-date training which Mobiletuning offers. This is held to be vital in today's world of rapidly changing vehicle engine technology. I was told that "On their own, they would just wither on the vine".

In turn, Mr. Rowntree sees a number of advantages for Mobiletuning in franchising. First, he believes that there are specialisation advantages in the franchisees concentrating on operations whilst Mobiletuning builds the brand image and provides training. Also, there is a major honesty problem in a business with many cash transactions in remote branches. He feels that vehicle tuning is not a sufficiently valuable business to be able to support an enormous administrative system. This would be necessary in a system using employees, which is the alternative organisational structure that could be used. Mr. Rowntree believes that in his system he is more able to rely on the honest conduct of franchisees and can avoid monitoring costs.

Franchisees are likely to require less monitoring over the honest conduct of their businesses because of four factors which increase the incentives for true performance revelations. First, the franchisor only has

the franchisee to monitor for a given outlet, as all employees become the franchisee's responsibility. The franchisee as a residual claimant has the motivation to monitor any employees, and as he is locally based is well placed to this. All of the franchisor's efforts can be concentrated on the franchisee. Secondly, the franchisee is highly committed to the franchise relationship because of his investment. He is less likely to wish to jeopardise this by dishonest conduct compared with an individual who would only risk damaging his reputation as an employee. Thirdly, some behaviour makes no sense when the franchisee is the residual claimant: there is, for example, no incentive to hide profits as costs as the royalty is levied on turnover. Finally, an employee who hides a sale benefits from the entire price, whereas a franchisee only saves himself the percentage royalty which he avoids.

Mr. Rowntree feels that there are no current capital-raising advantages to Mobiletuning from franchising. In the early days he might have found difficulty in raising finance for company vans but this would not now be so.

5. Fees and returns

An initial lump-sum franchisee fee of £3,000 is currently charged (1987). In exchange for this, initial training, franchise manuals, launch advertising and promotional material is provided. The franchisor does not aim to make profits on this fee.

The bulk of Mobiletuning's revenue comes from the 10% royalty which is levied on the franchisee's sales turnover. For this purpose, turnover is defined as the labour-charge component (around £25 in 1987) of the tuning services undertaken by a franchisee. There are no tied-in sales, but there are profits for Mobiletuning if

components or equipment are sold to franchisees. Mobiletuning aims to be very competitive with outside suppliers. Value Added Tax is added to all fees charged by the franchisor and then claimed back by the franchisee.

The cost of establishing a franchise in 1987 is between £10,000 and £16,000 depending on whether used or new equipment is bought. According to Mobiletuning's projections, an outlet will yield an annual gross profit of around £18,000, excluding provision for salaries or finance. Mr. Rowntree feels this is a good income for people working in this section of the economy. Mobiletuning is satisfied with its own profits. The franchisor's projection of profitability for a representative franchisee, undertaking around 1,000 tunes each year, is given as Appendix D. Mr. Rowntree reports a healthy demand for membership of his franchise system.

The franchisees

1. Franchisee D₁

D₁ began as a franchisee in 1982. Previously he was a cost accountant with XXXX XXXX, who made him redundant. He looked for a business opportunity into which he could invest his redundancy-compensation payment, which would use skills that he possessed, and which would provide a reasonable income for his remaining working life. D₁ approached Mobiletuning after finding that the rival Hometune organisation had no vacant territories. Hometune was the better-known brand at that time.

Equipment and parts are bought through Mobiletuning as D₁ finds this to be both more convenient and cheaper. However, he does add three non-tuning service lines to his business, which do not generate royalties for Mobiletuning. These are the fitting of car alarms, choke

conversions and car radios. They are small revenue generators which are accepted by Mobiletuning. About 85% of D₁'s tuning is of private cars.

D₁ feels that his obligations are to pay his bills to Mobiletuning and to promote the brand locally. He expects the franchisor to provide training, which is thought to be very important, and to monitor the system to preserve the reputation for quality work. The franchise is full format but in practice the franchisee is left very much to his own devices after much initial advice. D₁ reports that he has not met Mr. Rowntree since 1982.

D₁ confirms that Mobiletuning operates without frequent reference to the Agreement. Since starting up, this has only been mentioned once in his case, which was when a neighbouring franchisee was established and a territorial boundary had to be defined. He knew of no disputes, thought the system was operated very harmoniously, and valued his own independence.

When he began in 1982, the Mobiletuning name meant little in XXXX although this is changing now. D₁ believes that the major advantage of being a Mobiletuning franchisee is the technical back-up and continuing training.

D₁'s profitability is acceptable to him although not as good as he had hoped. Interestingly, he told me that the minimum requirement for paying a royalty equal to that generated on 40 tunes a month is not enforced in his case. D₁ confirms the structural details of the franchise system reported by Mr. Rowntree.

The franchisee is now an established specialist who is kept quite busy but is not fully occupied by his business. This is a home-based venture.

2. Franchisee D₂

D₂ became a franchisee in 1981 having previously worked as a service station manager. He was looking for an opportunity to become self-employed and was impressed with the low start-up cost attached to a Mobiletuning franchise.

Equipment and parts are purchased from Mobiletuning as this is found to be cheaper and easier than going elsewhere. D₂ does add an oil-change service to the business and this seems to be accepted by Mobiletuning, although it generates no additional royalties. About 80% of all work is on private cars, with the remainder being on company cars and light commercial vehicles.

D₂ believes that his obligations to Mobiletuning are to maintain standards of service and to pay the royalty. In return, he expects full support, particularly in technical areas. The know-how embodied in the franchise manuals was particularly useful when starting up. I was told "There would have been cars I could not have tuned without these guides". In practice, D₂ is left very much to his own devices now that he is established. The main advantage of being part of the network is the continuing technical support.

D₂ confirms the structural details of the franchise system reported by Mr. Rowntree and agrees that the franchisor does not operate by frequently quoting terms of the Agreement. D₂ feels his relationship with Mobiletuning to be a easy-going one. He knows of no disputes. He is very happy with his profitability.

The franchisee is now well established and is kept very busy by his business. It is a home-based venture.

3. Franchisee D:

D₃ began as a franchisee in 1981 after being made redundant in his previous engineering employment. He was looking for a business opportunity into which he could invest his redundancy-compensation payment and which would generate a reasonable income for his remaining working life. D₃ made his own comparisons of several franchises, including Dyno-Rod and Prontaprint, before seeking a Mobiletuning franchise. He was impressed by franchising in general because he understood that franchised new businesses have better survival rates.

About 50% of all supplies are bought from Mobiletuning. Otherwise a good local wholesaler is used, which speeds delivery times. In addition to offering tuning, D₃ fits sunroofs and car alarms, and undertakes servicing work. These extra lines generate no royalties directly for Mobiletuning. Nevertheless, the franchisor has been happy to supply separate, non-tuning invoices for D₃'s use. I was told: "I did not ask for permission but just told them what I do". About 80% of all work is on private cars.

D₃ confirms the easy-going nature of the franchisor. The Agreement is not quoted. He knows of no cases of dispute. When he was ill for a time, Mobiletuning rescheduled his payments and paid for a second launch of his business when he recovered. The franchisor is expected to provide technical support and to obtain discounts on parts. D₃ feels it is his obligation to maintain local standards.

The main advantage of belonging to the franchise network is the continual technical support it gives. D₃ believes that the value of the brand name is growing, however. He confirms the structural features of the

franchise system. Profitability is felt to be better than could be achieved by operating independently.

The business is home based and well established. It keeps D₃ fully occupied given the additional services that he offers.

4. Franchisee D₄

D₄ established his franchise early in 1986 having previously worked for 22 years as a fitter for the XXXX. He was led to Mobiletuning following discussions with XXXX advisors when he was made redundant. They helped him to examine the franchise, directed him to sources of finance, and explained to him the better survival rates for franchised new businesses which are commonly believed to exist.

About 80% of D₄'s business is with private motorists. He proudly told me that he also tunes cars for the local constabulary. About 50% of his parts come from Mobiletuning with the rest being bought from the same good local suppliers used by D₃ in XXXX. Like D₃, D₄ undertakes servicing work on separate Mobiletuning invoices but with no royalty payment implied. He claims that the understanding over this is that servicing must accompany an engine tune, as indeed it normally would.

D₄ sees his obligation as showing total loyalty to Mobiletuning and in return expects them to fully support him, especially by keeping him abreast of technical developments. He confirms that the franchisor is very easy going and knows of few disputes. He has heard that the Agreements of two franchisees have been terminated, for failure to pay monies due, since 1973. Otherwise, the Agreement appears to be largely forgotten about. The main

advantage of belonging to the network is definitely the technical support.

D₄ confirms the structural details of the franchise system. He is happy with his early profitability and would not wish to go independent. Interestingly, he was allowed to operate part-time until he felt sure that the business was viable. Part-time operations would not lessen financial commitment as the same equipment would be needed.

The business is not yet well established but keeps D₄ busy given the additional servicing work. It is home based.

Summary

Mobiletuning Limited operates a franchise system in which a 10% royalty is levied on the service charges of franchisees who operate mobile engine-tuning equipment. The franchisor is able to specialise in offering strong technical support which is highly valued by franchisees. He saves monitoring costs in a business which relies on cash payments and could be open to fraud. Mobiletuning has a reputation for easy-going operation of its franchise network and appears to have been very flexible in allowing franchisees to personalise their businesses. This flexibility has probably helped franchises to become established under quite poor market conditions to the ultimate benefit of the franchisor. It is worth noting that the extra lines mentioned by franchisees do not interfere with the quality of tuning services. Also, fewer extras are offered in XXXX where population density is higher and markets are larger for tuning alone.

The franchisor relies on the 10% royalty for most of his revenue. There are no tied-in sales and an initial

franchise fee would appear to be substantially spent by the franchisor at start-up. Some profit will be made on product sales, although the stocks held and used by franchisees are not large (stocks are worth about £1,000). However, even though no vital input is controlled by Mobiletuning, it is not strictly true that there is no scope for the extraction of economic rent from franchisees. The royalty payment (or initial fee) could be sent to extract rent in the original design of the Franchise Agreement if market conditions allowed rent to be earned. The franchisor has no scope for varying his royalty (at least in an upward direction) as Agreements are automatically renewable and royalty terms are not separately scheduled. It is strictly true to say that the franchisor could not capture any increase in profits in the business, unless these were solely due to his efficiency in procurement of parts.

Mobiletuning entered the business after the market leader, Hometune, and such entry would have reduced any rents which were present. This could explain the franchisor's lack of interest in setting up devices which leave freedom to capture profit increases: none were anticipated.

----- Subject to franchisee choice

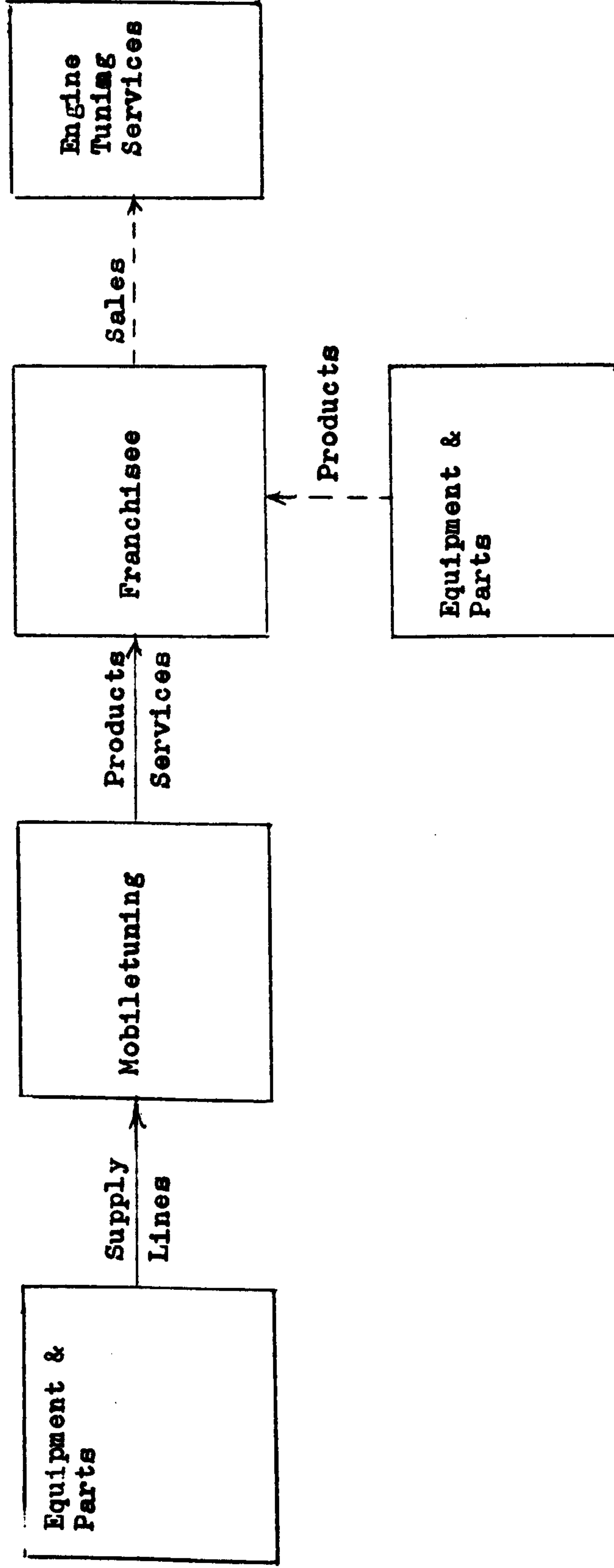


Figure D Mobilletuning Franchise System

HOW MUCH WILL YOU EARN?

| | First Year | Second Year | Third Year |
|------------------------|---------------|----------------|---------------|
| Number of Engine Tunes | 530 | 875 | 915 |

REVENUE

| | £'s | £'s | £'s |
|----------------------|---------------|---------------|---------------|
| Labour Charges | 13,118 | 21,656 | 22,646 |
| Parts Sales | 1,590 | 2,625 | 2,745 |
| VAT on Sales | 2,206 | 3,642 | 3,809 |
| TOTAL REVENUE | <u>16,914</u> | <u>27,923</u> | <u>29,200</u> |

EXPENDITURE

| | | | |
|------------------------------|--------------|---------------|---------------|
| Accountants Fees | 175 | 175 | 175 |
| Advertising | 1,200 | 1,636 | 1,711 |
| Franchise Fees | 1,312 | 2,166 | 2,265 |
| Insurance | 450 | 450 | 450 |
| Parts Purchases | 954 | 1,575 | 1,647 |
| Petrol/Oil | 398 | 656 | 686 |
| Service/Repairs/Tools | 223 | 735 | 769 |
| Telephone | 297 | 490 | 512 |
| VAT on Purchases | 684 | 1,115 | 1,165 |
| Payments to Customs & Excise | 1,522 | 2,527 | 2,644 |
| TOTAL EXPENDITURE | <u>7,214</u> | <u>11,525</u> | <u>12,024</u> |

| | | | |
|---------------------|--------------|---------------|---------------|
| GROSS PROFIT | <u>9,700</u> | <u>16,398</u> | <u>17,176</u> |
|---------------------|--------------|---------------|---------------|

| | | | |
|----------------------------|-------|-------|-------|
| Less provision for finance | 1,865 | 1,865 | 1,865 |
|----------------------------|-------|-------|-------|

| | | | |
|------------------------------|--------------|---------------|---------------|
| NET PROFIT BEFORE TAX | <u>7,835</u> | <u>14,533</u> | <u>15,311</u> |
|------------------------------|--------------|---------------|---------------|

NOTE: Expenditure shown above is for the first year in addition to the items on page 1.

Mobiletuning^{LTD}
CRYPTON TUNING AT YOUR HOME

CASE E YOUNG'S FRANCHISE LIMITED

The franchisor

1. Background

Young's Franchise Limited was set up in 1985 after Young's Franchise Group Limited failed. The company was bought from receivership from Cyril Spencer, a former chairman of the Burton Group. It now consists of Young's, a men's dresswear hire business and Pronuptia, which sells bridal gowns. Often the two businesses are combined in a single franchised or company-owned outlet. The failure in 1984 arose when a maternity-wear hire venture, La Mama, went wrong. The new company has dropped all maternity-wear interests.

A typical outlet has a floor area of 800-1,500 square feet divided into a shop area, offices and preparation and storage areas. Any number from three to 20 people might be employed depending on the size of the market which is served. There are 61 franchised outlets and a further 18 or so company-owned shops. 70% of outlets are combined Young's and Pronuptia businesses. Around 750 people are employed throughout the network. The company is at the beginning of a period of recovery from its financial difficulties, when it lost a number of franchisees.

Young's is a dresswear-hire business which was established in the 1930s. The first franchisees were created in 1975. Pronuptia was added in 1977 when the UK master franchise was bought from the French parent company. The UK rights to Pronuptia were renewed for a further 10 years in 1987. There is an agreement for minimum orders of bridal gowns from Paris but otherwise all products are bought competitively on open fashion markets.

Franchisees must buy their stocks from Young's franchise Limited, or hire them on an intershop-loan system which operates to meet some of the requirements of the Young's shops. Fractional franchises are rare, unless they involve the combination of a Pronuptia and Young's franchise which would normally be run by a husband and wife team. The company prefers stand-alone sites which are used for either or both of its brands. There is a policy of increasing the number of franchises as the company believes that profitable opportunities exist for new outlets. Existing company-owned outlets will not be converted to franchises but no new ones will be added. Some franchisees have more than one outlet.

Young's outlets mostly hire out men's formal wear. Sales of accessories or formal wear represent only about 5% of the business. Pronuptia shops exclusively sell bridal wear, accessories, and clothing for bridesmaids and other female wedding attendants.

The company belongs to the British Franchise Association. A National Advisory Panel which is elected by franchisees meets with the franchisor on a monthly basis.

2. Nature of the franchise

Mr. Norman Grossman, a director of Young's Franchise, granted an interview for this study. He sees franchisees' obligations as loyalty to the brand, participation in the intershop-loan system, buying products from the company, and abiding by the recommended procedures. In return, he believes that the franchisor must provide full support especially on the marketing side and must act as a monitor of standards of service.

A franchisee essentially has the right to trade under the Young's or Pronuptia logo, to participate in garment loans, and to receive general advice on running the business. He must buy products from Young's Franchise but nothing in his Franchise Agreement forces him to supply any particular customer. The franchise system is illustrated in Figure E, where arrowheads show the direction of sales links.

The company offers a full business-format franchise with manuals covering sales, operating and administration systems. Initial and continuing training is provided. There is no franchisor control on property leases although assistance can be given over obtaining these if it is required. No financial help is given to franchisees although the company can direct them to banks offering franchise financial packages.

Stocks are paid for by franchisees once they arrive at local outlets and are valued at around £12,000 for Pronuptia (and around £18,000 for Young's and £30,000 for a combined business). Other than stocks, there are no highly specialised assets. However the £12,000-£30,000 represents a considerable commitment in its own right.

3. Contract

3(i) The Agreement

Young's Franchise uses an extensive Franchise Agreement. A copy of the Pronuptia version of this was given to me by Mr. Grossman. It runs to around 40 pages. The Young's version is similar but also has clauses dealing with compulsory participation in the intershop-loan system. The principal clauses of the Pronuptia version are simply summarised below. A copy of the

agreement is available for inspection should this be required.

The Agreement gives the franchisor the right to veto any choice of premises, although the lease is to belong to the franchisee. In addition, the company must approve of the shop layout which has to use the standard livery. Young's Franchise will pay 50% of shopfitting charges.

The franchise granted is defined as the right to trade as Pronuptia within an agreed territory. The grant is for five years and may be renewed without additional fees. The initial franchise fee is not set in the Agreement but is inserted into a blank space left for the purpose. This is not true for the royalty payment which is defined as 10% of gross sales turnover each month. Gross turnover excludes VAT. Overdue payments incur a 0.5% a week interest charge (a 24% annual percentage rate). The franchise must make weekly sales returns using company forms. VAT is charged on all fees levied by the franchisor but may be reclaimed by the franchisee.

The franchisor agrees to spend 30% of his monthly royalty on central advertising, whereas the franchisee agrees to spend 3% of his gross turnover on local advertising. The company has the right to vet any local advertisements. The franchisee may seek contributions from Pronuptia or from other franchisees towards advertising which will give benefits outside of his territory but he cannot force others to pay.

The franchisor's obligations are listed in very general terms for the most part. Advice is to be given whenever it is sought. The company will train a nominee of the franchisee for up to four weeks before the business start up. Marketing support and company stationery, including invoices, are to be supplied at the franchisor's

expense. Products are to be procured economically and transfer pricing should aim for a 120% mark-up for franchisees. The company will assist with opening a new franchised outlet and will pay 50% of launch-advertising costs. An annual fashion viewing must be organised. Manuals covering sales, operations and administrative procedures must be supplied to franchisees.

The franchisee agrees to follow the standards common in the company network and to pass on any complaints not resolved within 14 days. The franchisor's rulings over complaints are to be accepted. Each year, copies of the franchisee's business plan must be supplied to the company. Only Pronuptia supplies are to be used unless the franchisor's permission is granted to use some line, which must be exclusive to the franchisee in his area. Defects in products are to be notified within seven days or else accepted by the franchisee. £500,000 of public-liability insurance is to be carried by the franchisee, who fully indemnifies the company against claims. The franchisee must have no competing business interests, and he must not solicit the franchisor's employees to come and work for him. He will submit an annual audited profit and loss account to the franchisor.

The franchise may be transferred with the franchisor's consent and it may also be inherited by the franchisee's beneficiaries. The company will provide a manager for up to six months, in the event of the franchisee's death or disablement, at a charge equal to salary plus expenses. At the end of this period the franchisor can buy back the franchise at its market value, or terminate the Agreement, if no buyer has been found. a 5% commission is payable if the franchisor introduces a buyer. No mechanism is given for deciding market value.

The franchisor may terminate the Agreement without notice if the franchisee becomes insolvent or if he does not correct poor service quality. This last ground appears to be open to the franchisor's discretion in its interpretation. Buying outside, becoming involved in other businesses, infringing the trade mark or imparting know-how leads to the franchisee receiving 28-days notice to correct a contractual breach. Failing this, the franchisor may terminate.

The Agreement contains some technical details: non-enforcement of a right is not a waiver; each contractual clause is severable; the Agreement is held to be the entire contract; and the franchisee has no powers to represent the franchisor without authority.

3(ii) Implicit aspects of the contract

Mr. Grossman emphasises that the company tries to avoid conflict in its relationship with franchisees. He is able to identify three areas in which understandings have arisen. First, regular training sessions will be attended by a franchisee's staff. This is not provided for in the Agreement. From time to time the franchisor wishes to train in an aspect of the business and expects franchisees to cooperate in this. He is under pressure to ensure that such training really is relevant.

Secondly, it is understood that small sidelines may be carried by franchisees in their shops. An example would be Pronuptia shops selling locally made bouquets, which is a common practice although it is prohibited in the Agreement. Such lines are often not locally exclusive and are usually not subject to permission from the franchisor. They probably help to boost sales and indirectly benefit the company.

A final area in which understandings have arisen concerns disputes over advertising or territory. These are resolved by compulsory binding arbitration. There is no provision in the Agreement for this.

3(iii) Enforcement and monitoring

The franchisor does not believe in regularly quoting the Agreement at franchisees and believes that the value of the relationship causes them to fit in with the spirit of the contract. Some disputes have arisen over such things as franchisees buying products from outside sources, poorly maintained shops, inadequate stocks, unacceptable advertising materials, and non-payment of fees.

Mr. Grossman outlined a three-stage procedure to me. The company normally exhorts franchisees to end unacceptable practices and is successful in this. Franchisees who persisted in contractual breaches would be encouraged to sell their businesses either to a third party or back to the franchisor. Finally, an Agreement could be terminated. Mr. Grossman believes that six terminations have occurred: all of these were for non-payment of fees.

During the receivership period in 1984 a number of franchisees left claiming that the failure broke the Agreement, but tried to continue using the Young's or Pronuptia name. The franchisor did not wish to dispute in the courts over this as a consequence of losing a case would have been to undermine all Agreements. At the very least, bad publicity would have accrued to Young's Franchise. I quite independently have discovered that in at least one of these cases, Finchley in London, a company shop has been opened nearby. The intention appears to be to compete vigorously with the resigned franchisee.

Franchisees have initiated disputes over such things as delivery times, pricing and advertising. Often these date from receivership days. Mr. Grossman insists that the franchisor has improved matters in these areas during the recovery period and there is now less dispute. This is confirmed by franchisees. The areas which caused franchisee dissatisfaction are interesting. There is no clause in the Agreement governing delivery times. The one covering transfer pricing is very weak: setting the franchisee's mark-up does not guarantee competitive prices. During receivership, central advertising more or less dried up.

Mr. Grossman describes the costs of monitoring franchisees as "acceptable". Apart from monthly sales reports for the purpose of paying the royalty, weekly sales returns are made. The franchisor relies on his experience of running company shops, tied-in sales, and occasional observation of day-to-day activities to encourage honest reporting of results by franchisees. Mr. Grossman believes that franchisees would not wish to jeopardise their long-term business interests by excessively under-reporting sales or buying extensively from outside. Business costs are closely monitored only for new franchisees in order to help their management. Otherwise, audits are made quarterly, which is quite frequently compared with other franchise systems. Area managers visit franchisees roughly once in every six weeks.

4. Why franchise?

Mr. Grossman believes that Young's Franchise can offer prospective franchisees a strong brand name under which to trade. In addition, the company aims to give good general-management support so that franchisees should feel more secure in their businesses. It is felt likely

that franchisees would be better placed to survive recessions in demand because of the franchisor's management skills. Finally, the intershop-loan system for Young's should keep costs down for franchisees.

The franchisor recognises that he is better able to control the quality of his brand image by running a franchise system or company shops, compared with distributing through independent menswear retailers. Mr. Grossman feels that the company gains much from the entrepreneurship of franchisees at the local level. Self-employment is much more likely to lead to alertness to opportunities for generating new business or controlling costs than an employee bonus scheme, however good this might be.

Problems of ensuring the honest reporting of sales are believed to be eased by franchising. The franchisee has a lot invested in his business and will be less likely to defraud, compared with an employee, as the Agreement could be terminated were irregularities discovered. Mr. Grossman emphasises this benefit.

Mr. Grossman believes that there are capital-raising advantages to franchising. I was told that "It would have cost a fortune to build this network at £80,000 for each shop". This is a common view among franchisors which does not bear close examination. Shares could always be sold in the company without requiring the managerial participation of investors.

5. Fees and returns

Apart from the sales royalty of 10% which is discussed above, Young's franchise charges an initial lump-sum fee of £10,000 for a Pronuptia or Young's franchise, or of £15,000 when these are combined. In

exchange for this, the franchisee receives 50% of the cost of all start-up advertising, franchise manuals, training, the design of a shop layout, and a press launch. The franchisor does not aim to make a profit from the initial fee. Franchisees confirm that the fee is largely spent at the start. Both the initial fee and the royalty may be set to extract any economic rent arising at the retail end of the business. However, these may not be varied once the Agreement is in place.

There is a profit component in the transfer price of products. However, Mr. Grossman maintains that he is very aware that shops are price-takers. Excessive transfer prices would drive them out of business. If this is so, then the tied-in sales could not be used to extract economic rent from franchisees as there would be none to take. The facility would be there if market conditions changed.

It costs £45,000 to set up a Pronuptia shop, £51,000 to set up as Young's, and £78,000 to combine the two businesses. Estimates of start-up costs given to me by Mr. Grossman are recorded in appendix E1. No profitability projections were supplied. Mr. Grossman described the business as profitable for both the franchisor and franchisee, although it is accepted that the current period is one of recovery from financial difficulty.

Mr. Grossmann asked me whether it was common for fees to be charged for renewal of franchise agreements. This matter had been under discussion among the directors. I informed him that practices varied among franchisors.

The franchisees1. Franchisee E₁

E₁ has the largest franchise arrangement within Young's Franchise. He operates Young's and Pronuptia shops in XXXX and a combined unit in XXXX. I met him in his XXXX offices but observed both XXXX and XXXX shops. In total, he has 34 employees. He began in 1979, having previously been a self-employed journalist.

Interestingly, the clause in the Agreement restricting other business interests has been modified in E₁'s case to enable him to operate a specialist dry-cleaning business from his premises. This service supplies replacement uniforms for hotels and similar establishments whilst cleaning takes place. The sideline fits in well with the Young's hire business. In addition, and in common with other Scottish franchisees, E₁ can offer highland dress for hire but, unlike with the cleaning business, sales receipts count towards the royalty payment. Highland dress is an example of an exclusive local line supplied with the franchisor's consent, as permitted by the Agreement.

E₁ believes that his obligations are to run his own business efficiently and to maintain the high quality image of the brand in his locality. He expects full support from the franchisor, who should also monitor the overall quality of service in the network. His main advantage from belonging to the system is the ability to trade under the brand name. The products are of high quality, according to E₁, which is the basis for the brand image. Apparently, it is not worth using the intershop-loan system if a garment will be hired more than three times in a shop. As a large, multiple franchisee, E₁ is

left to run things very much his own way. He controls his own leases.

E₁ provided some useful comments on the failure of the original company. At the receivership stage, the franchisees took legal advice and concluded that their best assurance of liability discharge by the franchisor was their future commercial value if he managed to remain in business. Although one or two went independent, many franchisees were "very tolerant" as Young's Franchise recovered. At times, suppliers were difficult both from the company, and, as debts had been left unpaid by the failed business, also from outside. The position is now improved, although the unpaid debts make some firms reluctant to deal with the new company. Interestingly, Young's Franchise tries to encourage unincorporated status among its franchisees (although E₁ operates as a limited company).

The franchisee confirms that Young's Franchise does not regularly quote clauses from the Agreement. On the whole, monitoring has been light, particularly as Scotland is distanced from London. E₁ requested that the company tighten up on its checks on franchisee sales reporting. There are now seven managers charged with this task. He believes that all franchisees should contribute fairly to central costs.

The franchise network is fairly dispute free. E₁ confirms Mr. Grossman's claim that most disputes have been over the business failure. He is aware that there have been a few terminations over non payment of fees. Also, apart from the one or two franchisees who went independent, a few more sold their franchises because of the failure.

E₁ is happy with his own profitability and believes that the business is fundamentally sound. He confirms the structural details of the franchise system outlined by Mr. Grossman. He is aware of no company sales targets for his business. Based on his knowledge of the trade, the transfer prices would appear to contain a small profit element.

My observations were of a busy locally based business.

2. Franchisee E₂

E₂ opened a combined Young's and Pronuptia shop in partnership with his wife, in XXXX, in 1982. Previously he was employed as a senior manager in the retail trade. The combination is found to be effective, with bridalwear sales leading to menswear hire. Most products are bought from Young's Franchise as tied-in sales. Highland-dress hire is also offered, along with sales of outfits for mothers of brides. These local lines lead to royalty payments. Bouquets and accessories are sold without incurring royalties. There are five employees.

E₂ sees his obligations as maintaining standards of service in his area and paying his fees to Young's Franchise. In return, he expects good product ranges and centralised marketing support. He is left to run his business without excessive interference and values his independence. The main benefit of being a franchisee is felt to be the use of the brand name. The intershop-loan system is again not as highly valued as the franchisor might believe.

E₂ confirms that the Agreement is not regularly cited. He described a number of implicit aspects of his contract. Small quantities of products may be bought from

outside the network without provoking the franchisor into action. No value could be quoted for this, but a franchisor would know what would be reasonable in a given situation. Also, the clause in the Agreement requiring the franchisee to spend 3% of turnover on local advertising is not enforced.

Interestingly, at the start of the business, E₂ took his lease through Young's Franchise. He was concerned about the implications of this for giving the company a means of extracting some of his profits. An exchange of letters guaranteed that the property rent would be passed on without a profit for Young's Franchise. When he renewed his contract in 1987, E₂ took control of his own lease.

E₂ is aware that there have been some disputes in the franchise network, mainly at the time of receivership. He believes that most franchisees were very tolerant and stood by the company at a difficult time. Over the years, he has come to feel that the franchise fee has bought him less and less in return. He signed again with Young's Franchise partly because he felt the brand name to be useful and partly because he feared that a company shop would be set up to compete with him if he went independent.

The franchisee confirms the structural details of the system. However, he feels that there could have been a profit element in his initial fee as he received no design help with his shop. Although he believes he could make more profit working independently, he also feels that survival prospects are better as part of a multiple-store chain. The belief in higher profits from independent operation does not accord with the fear of competition from company shops. It is most likely that E₂ is thinking

of his current need to cover his costs and pay a royalty, compared with an independent, when making this point.

My observations were of a busy locally based business. It is run with care by E₂, who takes pride in his independence yet wishes for some of the benefits of having a nationally known brand name.

3. Franchisee E₃

E₃ began as a Young's franchisee in XXXX in 1982. He had previously been in partnership with his brother in a menswear business until they fell out with each other. Now they engage in intense rivalry rather like a couple of characters in a Compton MacKenzie yarn. E₃'s brother offers a men's formal-wear hire service in his shop based on the rival Dormie company.

The remarkable thing about E₃'s franchise is that it is a fractional one. He has been allowed to establish the Young's menswear franchise on the upper floor of his men's outfitters shop. Moreover, he has rented out a part of that floor to a footwear business. The shop is fitted out as XXXX XXXX XXXX with Young's and XXXX XXXX XXXX added as shops within a shop. Even in the Young's section, E₃ did not like the store design offered by Young's Franchise and modified colour schemes to his own taste. Yet, he received all normal franchisor support for the Young's part of his business including 50% of his launch advertising costs. An example of a lunch advertisement is given as Appendix E2 and clearly shows the individualism of E₃'s business. He employs 10 people, although only three of these are full time.

E₃ believes that his obligation is to maintain the quality of the Young's service in his area. He expects the franchisor to maintain the quality-brand image of the

products by centralised promotion and by careful buying of products. The main advantage of being a franchisee is seen by E₃ as being able to trade under the Young's name in the formal-hire side of his business. Yet he had never wanted to commit himself to only trading as Young's, but has continued to use his own name for the full business. In becoming involved with Young's, E₃ saw an opportunity to add what he assessed as an high quality products to his existing business. Franchisor involvement in his management of the shop is low. He controls his own lease.

E₃ does not participate very much in the intershop-loan system, preferring to own his stock. He must supply garments when he is requested to do so. His preference for keeping his own stocks is due to cost: if a garment is hired more than three times in a shop then it pays to have bought it. His stocks are extensive - a fact which he demonstrated by fitting my more than six foot frame with a tailcoat whilst I interviewed him. Sometimes he has experienced delay in receiving payments due to him under the intershop-loan system.

The disputes mentioned by other franchisees, arising due to receivership, are also known to E₃. However, apart from the overdue intershop-loan payments, he has never experienced any disagreements himself. In that case, the matter was resolved after E₃ withheld his franchise fee until the debts were paid.

E₃ confirms the details of the franchise system reported by Mr. Grossman. Also, he has never experienced the franchisor citing the Agreement. Clearly, the individualism demonstrated by his own business format indicates that the franchisor will be flexible in entering an Agreement. A particular implicit aspect of the contract is that the clause in the Agreement requiring the

franchisee to spend 3% of his turnover ^{on advertising} is not enforced. E₃ is left to his own judgement in this area.

A £900 initial fee was paid. E₃ is certain that Young's spent more than this on launching him as their contribution to advertising came to that amount. Royalty is only paid on the Young's part of the business. E₃ is very happy with his profitability and takes great pleasure in performing better than his brother.

My observations were of a fiercely independent local businessman who had succeeded in obtaining the benefits of the Young's brand without losing his own shop's identity. E₃'s business investment is less franchise specific due to his fractional status.

Company outlets

To help in understanding the operations of Young's Franchise I interviewed Maureen Hamilton, the manageress of Pronuptia in Newcastle-upon-Tyne. This is company owned. The main aim of the interview was to check whether there are any significant operating differences between company-owned and franchised shops. I met her in her shop.

The branch became a company shop in 1984, at the time when the Young's Franchise business failure began. The franchisee remained with Young's, and only gave up Pronuptia, in Newcastle. Mrs. Hamilton used to work for the franchisee and so can compare both arrangements. There are seven employees of whom four are full time.

All supplies are from the company now, whereas the franchisee did run some local lines. A weekly sales report is made now, as before. Occasional visits are made by an area manager, a little more frequently than used to

be the case when the shop was franchised. Mrs. Hamilton feels more secure in her employment now that the shop is company owned, although in fact only 50% of the previous workforce has been retained. She believes that sales-recording systems and checks are sufficient to ensure honest reporting.

Mrs. Hamilton considers that the brand name helps to create sales in a very competitive business.

I infer from the reduction in the workforce and the franchisee's exit from this business that it was experiencing financial difficulties. The company has reorganised it to enable it to survive. The profitability of the branch was not discussed with me. Even if this is low, avoiding unnecessary closures would have been very valuable to the company in 1984. Mrs. Hamilton does enjoy a sales-related bonus as part of her salary.

The picture emerging from a comparison of company and franchised shops is that the company has better control over product lines in its own shops. In other respects, and leaving E₃ aside, the company shop is no different from a franchised outlet in its appearance and day-to-day operations. However, the company cannot rely on local entrepreneurship but must be more involved in running its own shops.

Summary

Young's Franchise Limited sells its products through its franchised outlets and a lesser number of its own shops. Sometimes products are hired when a Young's franchisee requests a garment on the intershop-loan system and this comes from a company shop. The picture is mainly one where franchisees invest in stocks and hire out men's formal attire or sell bridal wear. Tied-in sales leave

open an avenue for extracting economic rent from franchisees. Young's Franchise attenuates problems of monitoring honest reporting of retail performance by the use of the franchise system. It also benefits from franchisee entrepreneurship at the local level. The franchisor perceives capital-raising advantages to franchising. His revenue comes from an initial fee, a sales royalty and the prices charged for tied-in products.

Franchisees are given an intershop-loan system which appears not to be highly valued by them. The main benefit of belonging to the system is the right to trade using the brand name and the quality products.

In practice, the detailed Agreement is not enforced in a number of areas. Complimentary sidelines are permitted in the cases of all franchisees whom I interviewed. Revenue from these is usually not counted for royalty payments. In E₃'s case, the franchise has become fractional and he operates with a tailor-made Agreement.

Franchisor control of products ranges, shop layout and operations can be seen at its weakest in E₃'s case and at its strongest in the company-owned shop. In fitting in with E₃, Young's Franchise is not far removed from distributing its products through general retail outlets.

----- Subject to franchisee choice

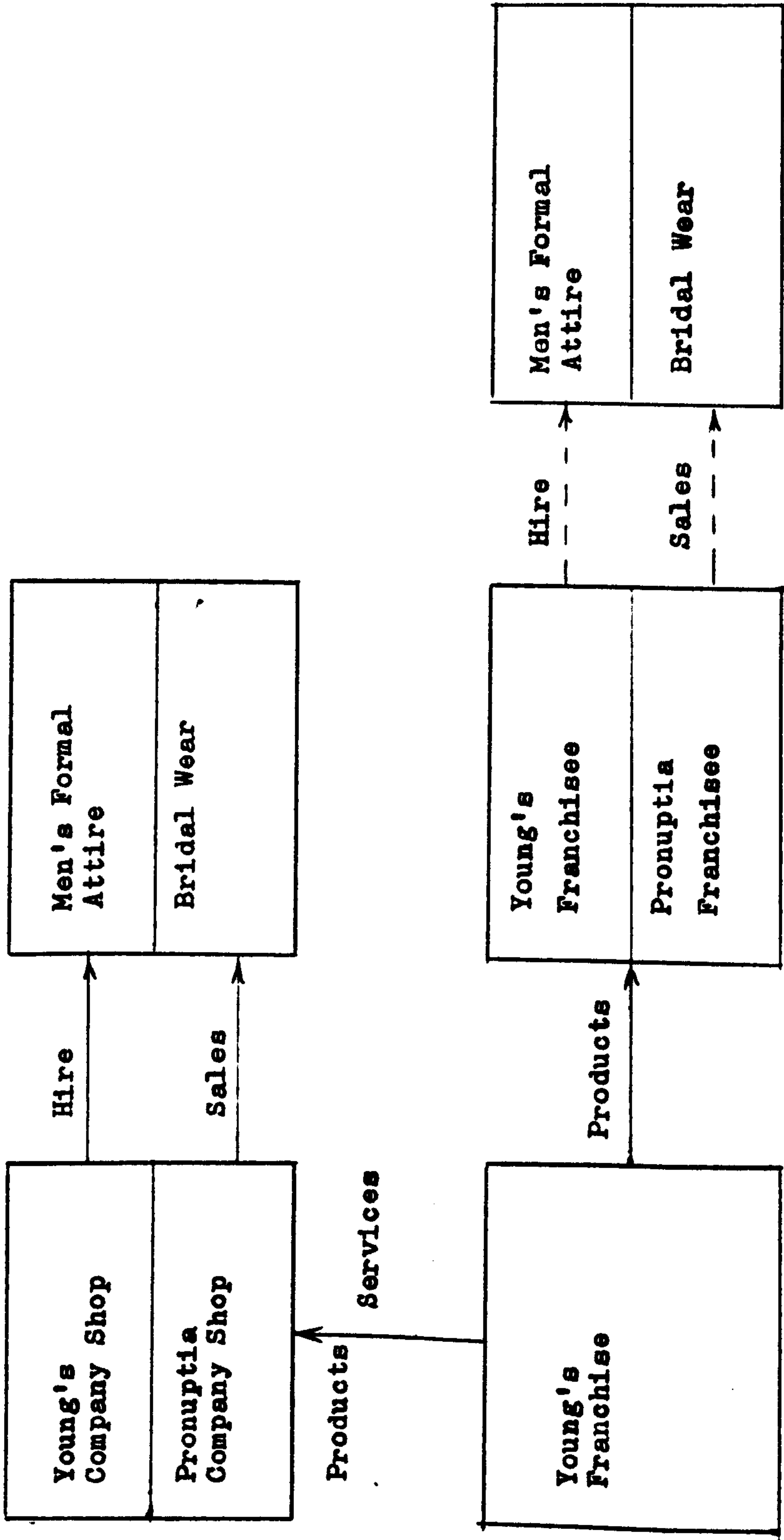


Figure E Young's Franchise System

ESTIMATED COSTS OF SETTINGUP APRONUPTIA & YOUNG'S FRANCHISE

| | <u>Pronuptia (£)</u> (Standing alone) | <u>Young's (£)</u> (Standing alone) | <u>Pronuptia & Young's (£)</u> (Combined) |
|--|--|--|--|
| Initial Franchise Fee | 10,000 | 10,000 | 15,000 |
| Shop Fitting Cost | 18,000 | 18,000 | 26,000 |
| Stock | 12,000 | 18,000 | 30,000 |
| Other start up costs, includ. legal fees circa | 5,000 | 5,000 | 7,000 |
| TOTAL | 45,000 | 51,000 | 78,000 |

NOTE

A typical Pronuptia shop is between 1,200 & 1,500 sq ft and a Young's no less than 800 sq ft the ideal size being 1,000 sq ft.

December 1986

AHH/DTB

PRONUPTIA

Youngs Franchise Limited



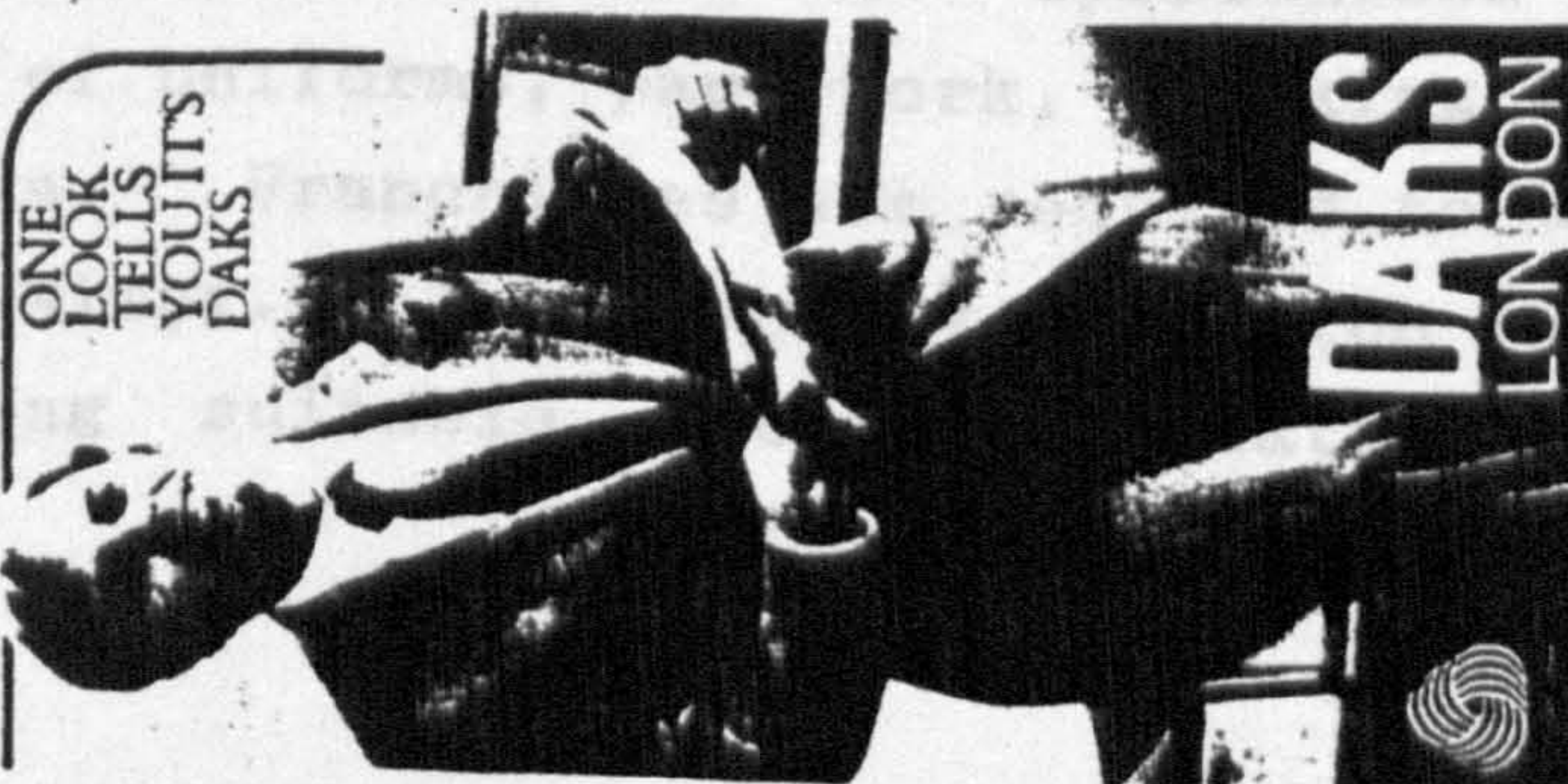
Young's

Reg. Office 70/78 York Way, London N19AG

Reg. No. 1964637

XXXX introduces —

EXCLUSIVE GENTS WEAR



SUITS

by DAKS, WEIDENMANN, KESTILIA OF FINLAND AND BERNHARDT

JACKETS

by DAKS, FARAH, WINCHESTER & WILBERT

CASUALWEAR

by FARAH, HONORBLIT AND BRASSON

SHIRTS

by VIYELLA, VAN HEUSEN, DE SOTO AND PETER ENGLAND

KNITWEAR

by MCRITCHIE OF EDINBURGH, PIERRE CARDIN AND WOLSEY

AT

XXXX STREET

XXXX

XXXX

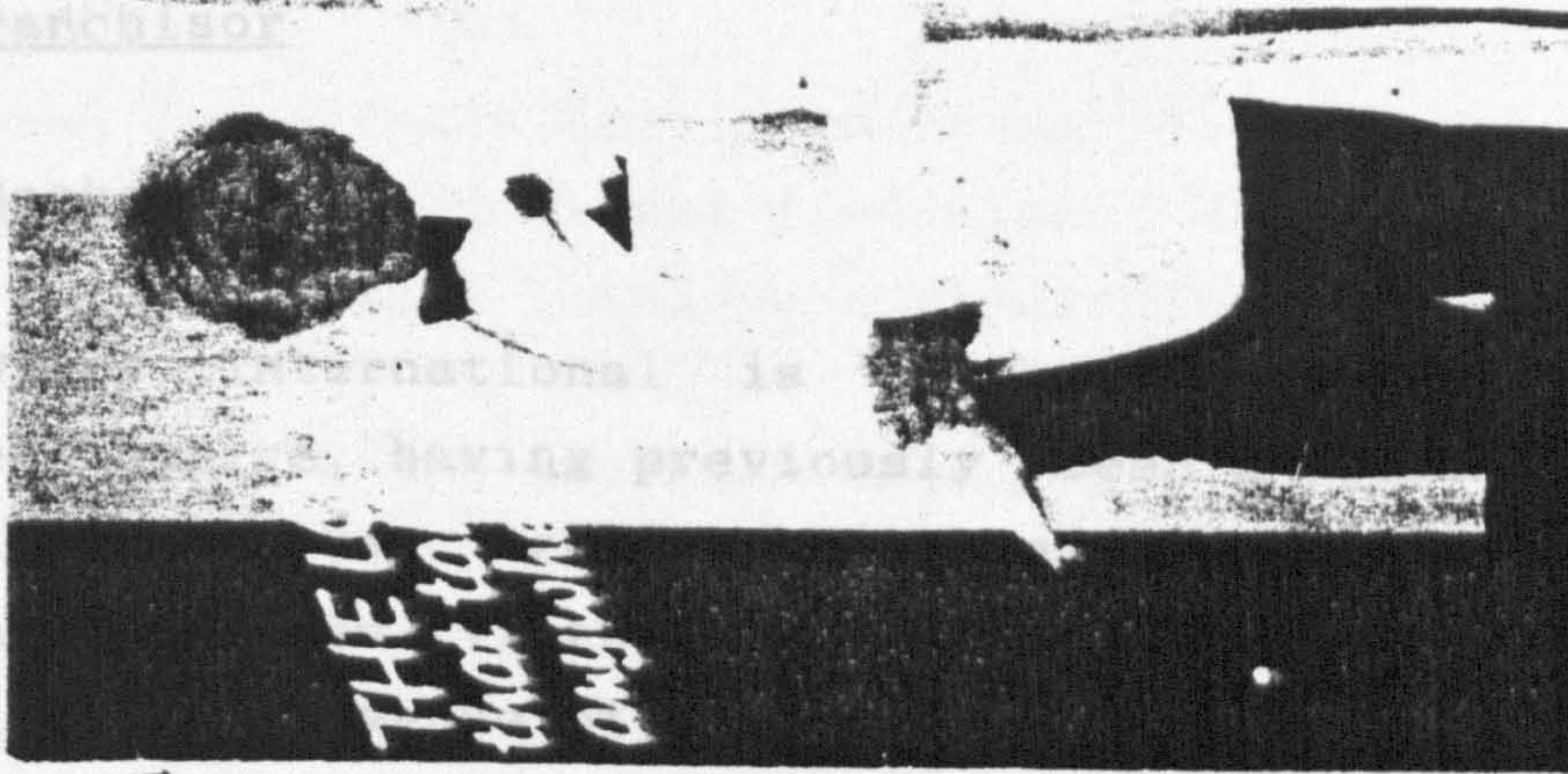
TELEPHONE:

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— introduces

Young's

formal wear for men



PROVIDING THE WIDEST SELECTION OF EVENING WEAR AND MORNING WEAR FOR HIRE OR FOR PURCHASE

EVERY STYLE IN THEIR CELEBRATED COLLECTION IS EXCLUSIVE. IMPECCABLY CUT, FINISHED TO THE HIGHEST FASHION STANDARD AND AVAILABLE IN A COMPLETE RANGE OF SIZES.

YOUNG'S FORMAL WEAR

HAS THE LOOK THAT'S EXACTLY RIGHT FOR YOU!

AVAILABLE

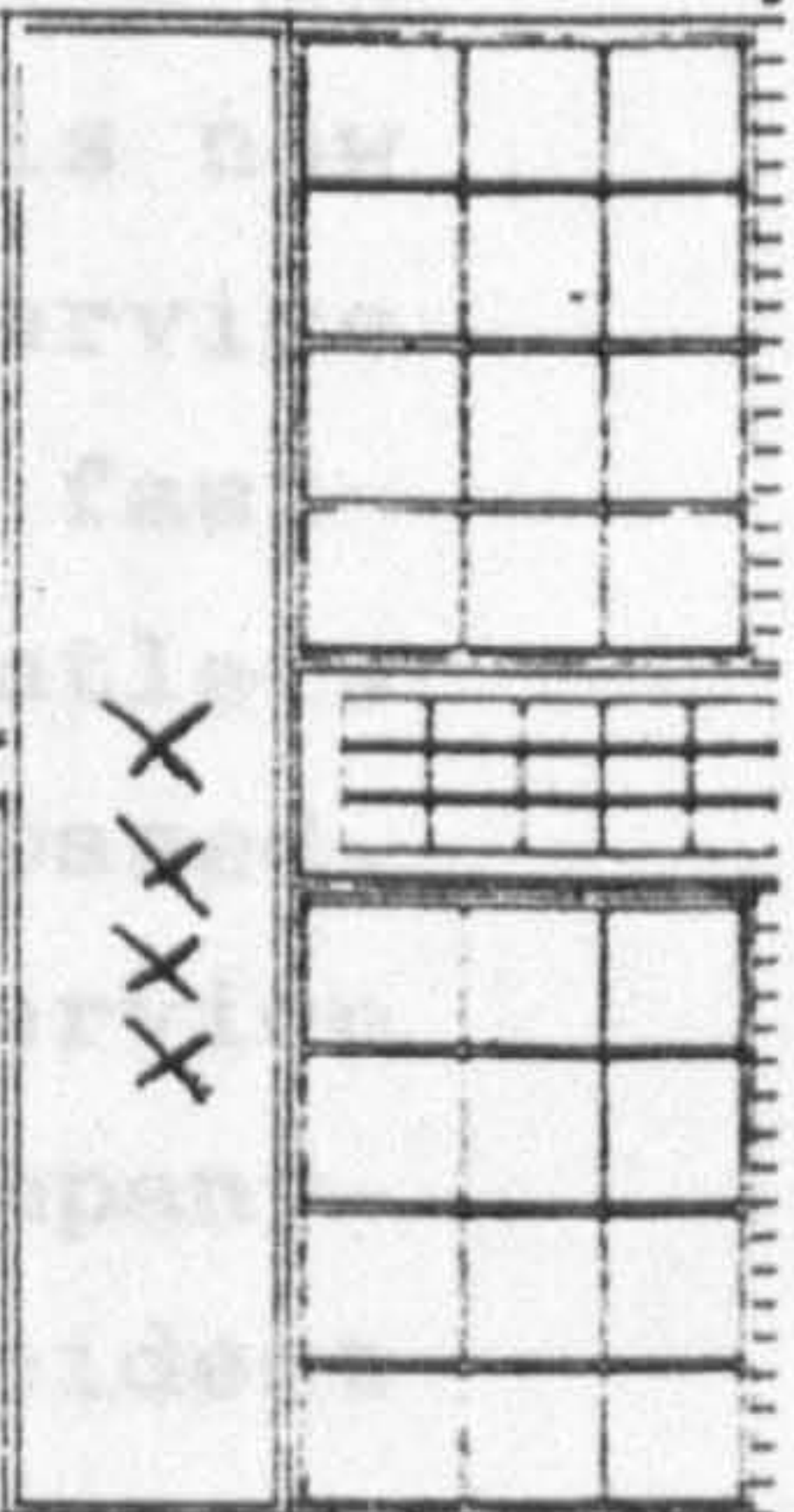
AT

STREET

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TELEPHONE:



CASE F - WIMPY INTERNATIONAL LIMITED

The franchisor

1. Background

Wimpy International is part of the United Biscuits business empire, having previously been a part of Allied Lyons. Wimpy has been operating since the 1950s and has always franchised virtually all of its outlets. The annual sales revenue of the entire Wimpy chain is around £100 million in the U.K. Approximately 12,000 people are employed throughout the network.

Since 1980, there has been a significant change in the nature of Wimpy's outlets. Prior to then, the business consisted of table-service restaurants with an average capacity of about 50 seats. The company is now phasing these out and moving over to a counter-service method of operation, along the lines of the American fast-food industry. Currently, in 1987, there are 432 outlets of which 117 are counter-service and 315 are table-based. 87 of the counter-service and 309 of the table-service restaurants are franchised. In fact, the six company-owned table-service establishments came about by accident as they used to be franchised to United Biscuits. Approximately 60% of total sales revenue is generated by the counter-service side of the chain.

Wimpy has its own bun and meat factories and a property division. There are specialised contracts with companies like Typhoo, Pepsi Cola and Coca Cola for supplies of drinks. There are also specialised contracts for the supply of uniforms, paperwork, drinking straws and in-shop displays. Franchisees are required to take these items through Wimpy. The property division is occupied with identifying suitable sites, negotiating with high-

street landlords, and designing and fitting out restaurants.

Some franchisees have more than one restaurant (in one case 12). Fractional franchises are not allowed as each restaurant must stand on a single-use site.

All outlets are designed to appeal to passing custom, especially within the under 35-years age group. A major competitor for counter-service business is Macdonalds. The American rival does not franchise its restaurants in the U.K.

2. Nature of the franchise

I interviewed Mr. Colin McGlashan, Scottish Franchise Manager for Wimpy, in Edinburgh. His comments refer principally to counter-service operations because table-service restaurants are being phased out and are less relevant to current business strategy. He believes that the franchise is essentially an investment opportunity for a franchisee who requires about £500,000 to set up a counter-service restaurant. Franchisees may well have other business interests and are likely to be involved in monitoring their restaurants rather than in actually working in them. Table-service franchisees would be more involved in catering operations management. Mr. McGlashan described the counter-service restaurants as "Factories which, once set up, can virtually run themselves following our very good systems".

Wimpy offers a full business-format franchise with manuals covering all aspects of operations, sales and administration. A franchisee uses a highly standardised restaurant layout, buys his products through Wimpy, and receives continuing training and marketing support. Wimpy essentially sells its products and applies its production

and marketing expertise through the franchise system. There is an expectation that franchisees will take leases through Wimpy, although it is argued that they would not be able to obtain these on their own. The franchise system is illustrated in Figure F, where arrowheads show the direction of sales. The franchisee does not formally give up his right to choose whether or not to supply a particular customer. The relative importance of table-service and counter-service, in the sales of the franchisees and of company-owned outlets, is indicated by the division of the markets shown in Figure F.

Mr. McGlashan believes that franchisees have an obligation to maintain the standards of service which are set up for the Wimpy chain as a whole. In return, Wimpy must monitor the system to weed out any poor units, give marketing support, and exercise purchasing expertise on behalf of franchisees. No financial support is offered, although Wimpy can direct franchisees to packages which have been devised by The National Westminster Bank and Barclays Bank.

The Wimpy System of Operation for counter-service restaurants is very detailed. Stocks are very fast moving and a delivery system ensures that only two-days stocks need to be held, keeping franchisees' stockholding costs to a minimum. Very precise standards are laid down in cases like restaurant cleanliness: for example, cleaners are continually active during opening hours. Recipes are completely standardised. Finally a system of waste checks operates to monitor efficiency and honesty within each restaurant.

A franchisee makes a large investment in a site layout and in equipment which could not easily be turned to other uses. He is contractually bound only to sell his business as a going concern and only with Wimpy's

permission. Any franchisee becomes necessarily highly committed to the chain.

3. Contract

3(i) The Agreement

Wimpy International uses a straightforward and fairly minimal, Franchise Agreement. A simplified outline of its main clauses now follows. A copy of the Agreement is available for inspection should this be required. The version analysed here is for counter-service franchisees, although the one for table-service franchisees is similar.

The franchisor undertakes to maintain the good reputation of the brand, to supply shopfitting plans and advice, to train the franchisee and to provide start-up help. Wimpy further promises to provide operating manuals, marketing support, new products from time to time, and economical supply lines. The company will be available to franchisees for consultation. These are all general undertakings and there is no attempt to tie down the details of advertising or transfer pricing, for example.

The franchisee is granted the rights to use all trademarks including the logo, to benefit from the goodwill, and to copy the operating methods belonging to Wimpy for a term of 10 years. The term is renewable provided the franchisee satisfies the conditions of his Agreement. There is no renewal fee. The franchisee gives a number of precise undertakings.

A franchisee's premises must meet with Wimpy's explicit approval. To this end, a schedule is attached to the Agreement specifying the approved premises. In practice, this is used to tie in premises taken by Wimpy

on a superior-lease agreement. There is nothing in the Agreement which rules out the case where a franchisee might make his own lease arrangements.

The lump-sum initial franchise fee is set in a blank space left for the purpose. It is currently £10,000 in 1987. In addition, a monthly royalty of 8.5% is to be paid on sales turnover excluding VAT. All franchise fees will carry VAT. The franchisor retains the right to inspect the franchisee's books to assess payments due to him, and anyway requires the submission of audited annual accounts.

The franchisee undertakes to conform to the uniformity of the Wimpy Chain. The appearance of buildings is to be agreed with the franchisor. All signs and equipment must be bought from Wimpy, as must all food and other supplies. A standard menu is to be offered during agreed opening hours running at least between 10 a.m. and 11 p.m. The franchisor is given the right to spot check the franchisee's business.

During the term of the Agreement, the franchisee will engage in no similar hamburger business without the written consent of Wimpy. This is an unusually liberal professional-limitation clause for a franchise agreement. It reflects Wimpy's expectation of attracting investors who are likely to carry a portfolio of business interests. Also during the term, the franchisee will indemnify the franchisor against all risks arising through the franchisee's operations, and will take out "prudent" amounts of employer-liability and public-liability insurance.

The franchisee will submit himself or a nominee to at least twelve-weeks initial training. Costs are met by Wimpy, excluding travel and subsistence.

The franchise may be sold with the franchisor's consent and subject to his right of first refusal to buy it at any price offered by a third party. Any purchaser acceptable to Wimpy must pay the company an assignment fee to be determined by not to be less than £1,000 plus VAT. The franchise is inheritable by the franchisee's beneficiaries should he die. No management help for beneficiaries is detailed in the Agreement.

The Agreement may be terminated by the franchisor, with discretionary notice, if operations are judged to be below standards, if there is default over fees, should the franchisee become insolvent or be convicted of serious criminal offences, if ownership or management of the franchisee's business changes in an unacceptable way, if inspection is refused, or if the franchisee sells non-menu items. Any other breach of the Agreement by the franchisee gives the franchisor the right to issue 30-days notice to terminate. On termination, the franchisee must sell back trade-marked items at the higher of market price or cost, if the franchisor requests this.

There are some technical clauses: the Agreement is claimed to be the entire contract between franchisor and franchisee; it is to be governed by the law of England; non-exercise of rights does not imply their waiver by the franchisor; and clauses are severable.

There are some interesting omissions from the Agreement. The franchisee cannot terminate by giving notice, although no doubt a breach of contract could easily be arranged by him to perform the same function. No significant professional limitations are imposed on the franchisee. Finally, there are no provisions for compulsory arbitration or for interest payments on overdue payments.

3(ii) Implicit aspects of the contract

Mr. McGlashan believes that there are three implicit aspects of the contract with franchisees which are worth noting. These are business understandings which have emerged and which are governed by the long-term value of the business relationship.

Although they would never advertise the fact, Wimpy would rescue a counter-service franchisee who fell into financial difficulties. Mr. McGlashan emphasises that this should not happen, given the level of market research which accompanies a launch and the franchisor's experience. However, it is felt that failures would be a very bad reflection on the chain, especially during the early days of counter-service franchising. There have been no cases requiring such help.

A second implicit aspect of the contract is that Wimpy always stands ready to act as superior lessee in obtaining high-street leases on premises for franchisees. High-street landlords are often reluctant to let their property for fast-food purposes and even Wimpy must on occasions pay a premium over going commercial rents. Landlords find that the subsequent rental value of a lease is affected by the kind of business which has operated from the premises. Fast Food has been regarded as a rather down-market activity with a lot of associated business failure. Consequently, individuals find it virtually impossible to obtain private leases. The normal practice is for Wimpy to take a lease for a counter-service site and then to sublet to a franchisee. Table-service restaurants tend to be away from prime sites and franchisees hold their leases fully in their own names.

Care is needed in analysing this understanding over counter-service leases as control of a franchisee's

property can be used by a franchisor as a mechanism for extracting any economic rent which may be present at the retail level. The understanding does not seem to operate as such a mechanism in this case. Wimpy takes a 25-year lease with an associated review of rent every five years. This is passed on to a franchisee as a 10-year lease with the same review of rent. The rental is simply passed on with an administration charge added. The handling charge is set in the sublease contract and is currently around 5% of the rental. Under these circumstances the franchisee is not vulnerable to variation of charges in a manner designed to remove any profits which he may be enjoying. Franchisees do not regard the handling charge as excessive, according to Mr McGlashan. This is confirmed by the franchisee interviewed below.

It should be noted that the possibility always exists for Wimpy to use the initial setting of the administration charge as a rent-extraction device. If it is the case, as it seems to be, that Wimpy's involvement is needed to obtain the lease, and since franchisees are not prevented from acting alone, or with the help of a third party, any rent extracted would be converted into factor earnings. The reward would go to the superior lessor's risk-bearing services.

The lease does not revert to Wimpy in the event of termination of the Franchise Agreement. Property control cannot be used to preserve the goodwill attached to a site in the hands of the franchisor. At present, it would seem that Wimpy provides a lease-obtaining service, in the case of counter-service sites, for which it receives its costs.

The third implicit aspect of the contract covers territory. There is nothing in the Agreement which grants a protected territory to the franchisee. Mr. McGlashan states that it is understood that a franchisee will always

have first refusal on any restaurant likely to impinge on his sales. In practice this is unlikely to be of great practical significance except in two cases. First, where the table-service network is being allowed to diminish over time, counter-service restaurants which are likely to compete with the older units are set up from time to time. The practice is that the table-service franchisee for the area is offered the counter-service unit. The other case arises when it is thought that establishing two neighbouring restaurants can return more revenue and profit than a single unit. In such a case, an existing franchisee would be offered the additional unit.

3(iii) Enforcement and Monitoring

Wimpy has a system of very close monitoring of the restaurants. The same methods are used both for company-owned and franchised outlets; they are also broadly similar for counter-service and table-service units. Sales turnover and all inputs are reported weekly. Daily conduct of the business is observed by operations managers who make unannounced spot checks at roughly monthly intervals. Quarterly audits are made of all restaurants.

Mr. McGlashan emphasises that the monitoring system helps to control the business for a franchisee. It is very difficult for fraud to go undetected. Wimpy knows what materials go into a unit and has a shrewd idea of normal waste rates. The routines prescribed for the franchisee include physical waste checks. At a counter-service unit it will be someone's job to inspect the dustbins at two-hour intervals to check the amount of waste. Everything must tally: waste, waste ratio, turnover and material inputs. The checks are of value to the franchisee, who could be losing money to dishonest staff, as well as of benefit to the franchisor.

Wimpy also has a clear idea of staffing levels which will be required for a restaurant. This results from company operating experience. The rule for counter-service is that 20% of all costs will arise on labour. The franchise system itself discourages fraud in this area anyway. Since royalties are levied on turnover and not on profits, franchisees have no incentive to hide returns as mythical labour costs.

Mr. McGlashan believes that the monitoring system is very efficient. The next step will be to computer-link all outlets with the centre.

Wimpy would not wish to quote contractual clauses to franchisees. The preference is for mutually advantageous development of the business. Mr. McGlashan thinks that "The franchisor is probably not tough enough with franchisees' on occasions". This is because it is felt that the pursuit of court cases would not be good for Wimpy's reputation as a franchisor.

There are occasional conflicts within the system between Wimpy and franchisees. These have often been over standards in the table-service restaurants and have been resolved through exhortation. No terminations have occurred nor have there been cases of franchisees breaking their contracts and leaving. A few franchisees have been bought out by Wimpy, although Mr. McGlashan declines to give precise figures. There are no obvious cases of encouraged sales of restaurants by franchisees to third parties. However, table-service franchisees are not encouraged to renew their Agreements.

There is a franchisee association which meets annually.

4. Why franchise?

Mr. McGlashan believes that franchisees mainly gain from trading under the Wimpy brand name, and by having access to high-street sites which would otherwise be denied to them. In addition, monitoring systems help the restaurants virtually to run themselves. Marketing support, including product development, is available to franchisees who would otherwise be working in isolation.

Wimpy benefits from franchising principally by being able to concentrate on property acquisition, purchasing, marketing and the design of operating systems, according to Mr. McGlashan. The franchisee concentrates on local operations, with support, and will be highly committed to achieving results. Wimpy operates its own restaurants; it is generally because of specific strategic or financial reasons (for example, two units have been set up in Princes Street in Edinburgh as flagship operations in Scotland).

Mr. McGlashan also perceives financial advantages to the franchisor from franchising. This perception is common among franchisors but does not stand up to analysis. Drawing in capital from investors may always be done without insisting on their participation in management.

5. Fees and returns

Apart from the £10,000 initial fee and the sales royalty of 8.5%, the franchisee must purchase his products from Wimpy. Mr. McGlashan maintains that there is no real profit component in either the initial fee or the tied-in sales. In many cases, it can cost Wimpy £25,000 to start up a franchise. Tied-in sales act to "standardise" products.

It is interesting to note that the franchisor has a number of possible routes for extracting any economic rent from franchisees. The initial fee, sales royalty and tied-in sales may all be used for this purpose as may the setting of the administration fee applied to any sublease which may exist. Once the initial franchisee fee and the sublease administration charge have been set, and given that the royalty is part of the renewable agreement, only the transfer prices of tied-in sales leave scope for the variation of the franchisor's returns.

It costs about £500,000 to set up a counter-service restaurant, a figure which often surprises. However, annual sales turnover is projected by the franchisor at a similar level. The projection of costs and returns are given in Appendix F. No sales targets are set for franchisees.

Mr. McGlashan believes profitability is "Better than average" for both franchisor and franchisee.

The franchisees

1. Franchisee F₁

F₁ began his counter-service restaurant in XXXX in 1986. He is a model of the new type of franchisee that Wimpy is seeking. His background is as a member of the Edinburgh financial community. He sold a farm and came in to some family money, and was looking for an investment when advice from The Royal Bank of Scotland suggested a Wimpy Franchise. F₁ also has an interest in a textile company.

There are 35 people employed on a shift system in the restaurant. Passing food trade generates the volume of business projected by Wimpy. About 5,000 customers pass

through the unit on a busy Saturday. Annual sales turnover is around the £500,000 mark. Mr. McGlashan's description of a counter-service restaurant as a factory was borne out by my observations: the staff man equipment which sends food to the counter and the customers. F₁ confirms that the operating plan can be followed virtually without variation. Even the division of his costs with 46% being spent on food and 20% on labour, is almost exactly as forecast. All products are bought through Wimpy.

F₁ sees his obligations to Wimpy as maintaining if not improving the brand image in the XXXX area. In return, he expects the company to develop the brand nationally and exercise quality control over the products. He definitely expects any poor outlets to be weeded out or improved. The main advantage to belonging to the franchise system is seen as the right to use the closely monitored operations procedures, with waste checks, standardised recipes and management support. F₁ believes that this is ideal for an investor who does not wish to spend all of his time involved in operations management. Apart from this, he finds the brand image of a standardised product useful in attracting customers who are often visitors to XXXX. Another benefit is on the product side: some supplies are half the price that an independent restaurateur would pay. Finally, F₁ believes he would not have obtained his lease without Wimpy's willingness to act as head lessee.

The franchisee does not find the written Agreement in any way onerous but does feel that abuses would lead to legal action from the franchisor. He feels that visits by area managers are to help rather than to monitor him. It is definitely an understanding that he has first refusal on any site which would compete with his, although there is no specified territory. F₁ thinks that occasional disputes are confined to the older table-service units:

"We all have too much tied up in the new restaurants to fall out with each other". He believes that his initial fee was more than spent by Wimpy at the launch.

F₁ confirms the structural details of the franchise which were reported by Mr. McGlashan. He is also able to make an interesting comparison concerning his own profitability. His returns are better than he would receive as interest on his capital from a bank but a little less than had been projected. He states that his annual profit, before interest, tax and depreciation and as a simple percentage of his investment, is around 13% at present. It should be remembered that the business is in its first year. F₁ is very happy with his investment and would like to take on another restaurant as soon as possible.

A final observation which I recorded whilst interviewing F₁ was that Wimpy could not hire a local manager of his calibre for the wages which would most likely be offered.

2. Franchisee F₂

F₂ opened her table-service restaurant in 1978, having previously worked as a catering manager for a different company. She had first refusal on the new counter-service franchise in XXXX, but declined it due to the size of the investment. Her own restaurant has 48 seats, employs seven people, and runs along more traditional lines. All products are bought through Wimpy. F₂ has another, unrelated, restaurant elsewhere in the XXXX area.

The franchisee sees her obligations as maintaining high standards of operation in her restaurant. In return, she expects Wimpy to maintain the status of the brand.

She feels that the brand name is the main advantage of being a franchisee. Whilst operating manuals were supplied, she did not need them due to her previous experience and the type of restaurant which she runs. F₂ is very much involved in the operations management of her unit. She holds her own lease on the premises.

F₂ does not find her Agreement to be burdensome and nor does she experience its citation by Wimpy. She accepts that the understanding over first refusal on a competing development was honoured by Wimpy, but is disappointed that the company has gone ahead with a different franchisee in her town. On the whole, her experience of the franchisor was of a "fair-going" partner.

Profits, which were "very good", have fallen as a result of the counter-service development. However, F₂ has no intention of leaving the system when her Agreement comes up for renewal.

Company-owned restaurants

Mr. Andrew Hirst, Manager, Princes Street One, Edinburgh

I interviewed Mr. Hirst at Wimpy's counter-service restaurant known as Princes Street 1 in order to make some comparisons between company-owned and franchised units. Mr. Hirst is the manager of the restaurant which, along with its sister unit in Princes Street, acts as a flagship operation in Scotland. He joined Wimpy as a graduate trainee in 1982 and has had four specific posts leading up to the present one. It should be emphasised that no sideways comparison is being made here between Mr. Hirst as the manager of a counter-service restaurant and F₁ as a franchisee. The latter employs a manager with many of Mr. Hirst's functions.

Managers like Mr. Hirst have short tours of duty at any one restaurant of about a year's duration. Around five managers report to an Area Executive. Their operations are firmly tied to company procedures. Mr. Hirst has a free choice over his expenditure only with respect to a small operating expenses budget, which is used for purchasing things like light bulbs. As a company manager he must make daily cost as well as revenue reports. He knows that franchisees have much more cost freedom as they are monitored principally on results. For franchisees, it does not matter how results are attained although labour and food costs cannot be varied without jeopardising results.

In practice, there is no significant difference between the appearance of a franchised and a company-owned counter-service restaurant. Mr. Hirst states that franchised units might be less well lit during quiet periods and franchisees save on lighting costs using their greater freedom over inputs. Otherwise, layout is similar, staffing levels are identical and the same menu is used.

Franchised counter-service units have made an impact on Wimpy's scheme of remuneration for staff. In early 1987, a profit-related bonus scheme was added to managers' pay. Mr. Hirst believes this was because the franchisees had introduced good bonuses for their managers and Wimpy became concerned about recruitment.

Mr. Hirst believes that he achieves an acceptable level of profit in his restaurant although the opening of the second unit in Princes Street did lower his returns. He knows that overall profits are better on the two units than either shop could make in isolation. Wimpy opened up in Princes Street to provide a visible model for Scottish potential franchisees. The second unit opened to pre-empt

any intention a competitor might have to start up along Princes Street. The units are at each end of the street. In time, one of the two may well be turned into a franchise.

Summary

Wimpy represents a mature franchise system which was initially established in the 1950s. In recent years, operating methods have moved from table-service to counter-service techniques. An associated problem has been the need to run down the established network of table-service restaurants without simply abandoning existing franchisees. In general, this has been achieved by offering counter-service opportunities to table-service franchisees. Often, however, it is a new breed of investor franchisee who is taking up the modern units. The new system appears to be designed to give profits which are just a few percentage points better than interest payments on banking deposits.

The franchisor uses the current system to sell products and well-developed restaurant-management systems. Comparing franchised with company-owned counter-service units monitoring problems are less severe: franchisees can be more easily trusted over honest reporting and are naturally inclined to take care over inputs. Franchising places a layer of high-quality management at the local level.

Franchisees benefit from use of the brand name, from low-cost products and from well-designed operating methods. Wimpy has a number of instruments through which a division of business returns between franchisor and franchisee can be set. These are the initial fee, the royalty payment, transfer prices for tied-in sales and property-lease management charges. Of these, the royalty

payment appears to be the main source of Wimpy's business returns. Products are transferred at low prices containing modest mark-ups. Leases are not always under the control of Wimpy and, when they are, appear to be very fairly managed. The initial fee can be more than spent at a launch. However, once set, the royalty is difficult to vary. The only possibility for collecting any economic rent which might arise at the retail end of the business would be through the transfer prices of products. To the extent that any economic rent depends upon advantages conferred by The Wimpy System, its extraction amounts to its conversion into factor earnings accruing to Wimpy.

--- Subject to franchisee choice

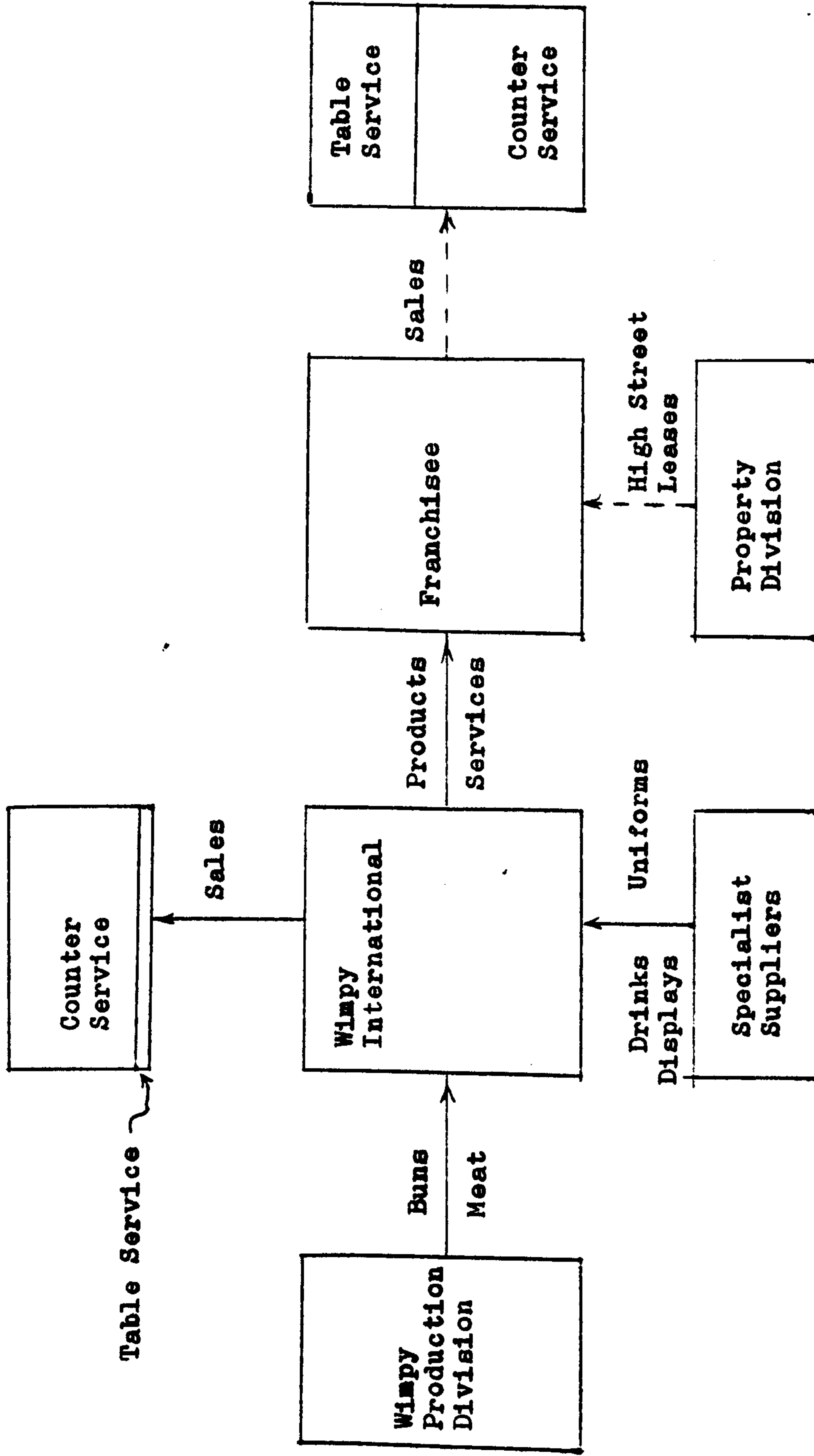


Figure F Wimpy Franchise System

WIMPY

2. Counter service projection

| Initial investment | | £K | £K |
|--------------------------|------------------------|-----|-----|
| Fees | Franchise | 10 | |
| | Estate agent | 4 | |
| | Building surveyor | 1 | |
| | Structural engineer | 1 | |
| | | 16 | 16 |
| Property | Solicitor etc. | 5 | |
| | Stamp duty | 1 | |
| | | 6 | 6 |
| Construction | Ventilation/heating | 50 | |
| | Building & shopfitting | 165 | |
| | Kitchen equipment | 95 | |
| | Signs & Fixtures | 40 | |
| | | 350 | 350 |
| Pre-opening | Training | 20 | |
| | Wages | 1 | |
| | Operating costs | 1 | |
| | Rent | 8 | |
| | | 30 | 30 |
| Total initial investment | | | 402 |

| Five year profit (cash flow) | Year 1 £K | Year 2 £K | Year 3 £K | Year 4 £K | Year 5 £K |
|---|--------------|--------------|--------------|--------------|--------------|
| Turnover 100% | 500 | 550 | 605 | 665 | 732 |
| Food cost 37.5% | 187 | 206 | 227 | 250 | 275 |
| Wages 20% | 100 | 110 | 121 | 133 | 146 |
| Operating costs 9% | 45 | 50 | 54 | 60 | 66 |
| Franchise contribution 8.5% | 43 | 47 | 52 | 57 | 62 |
| Rates | 16 | 19 | 21 | 23 | 26 |
| Rent | 40 | 40 | 40 | 40 | 40 |
| Profit (cash flow) Before interest, tax and depreciation | 69 | 78 | 90 | 102 | 117 |

CASE G PIZZA EXPRESS LIMITED

The franchisor1. Background

Pizza Express Limited was established in 1965 by Peter Boizot the well-known London-based entrepreneur. The company now comprises 40 pizza restaurants, of which 28 are franchised. The chain is concentrated in and around London; and the 12 company-owned units are all in Central London. Franchisees between them employ about 300 people. On top of this figure, the company employs around 100 more, giving a total of roughly 400 employees. Approximately 80,000 customers are served each week by the chain, which has an annual sales turnover of about £30 million. Franchising was begun in 1972 originally as a means of retaining a manager who wished to set up his own restaurant.

Each restaurant seats 80 or so customers and serves pizza dishes in stylish surroundings. A Pizza Express restaurant is often used for business lunches or for meals after theatre visits. Menus must be distinguished from those of fast-food outlets: Pizza Express offers classic pizza meals in a true restaurant setting. A company-owned warehouse operates to supply the restaurant with food and drink.

Fractional franchises are not permitted as the company prefers stand-alone sites. Some multiple franchises exist, although large sub-chains would not be encouraged. One franchisee has eight restaurants. Even so, in general, no franchisee would be likely to be offered more than two or three sites.

Pizza Express is a member of the British Franchise Association. There is also a franchisee association within the company which meets once every six months.

2. Nature of the franchise

I interviewed Jonathan Dell, Franchise Manager for Pizza Express at the company's Wardour Street restaurant. He believes that franchisees are obliged to maintain the company's brand image of quality food and service in their restaurant operations. Keeping to specified recipes and designs are the important aspects in this. In return, Mr. Dell considers that the franchisor should be available for consultation and advice, and that he should monitor the entire restaurant chain to ensure standards are met.

Pizza Express offers a full business-format franchise with manuals covering recipes, and other operating, administration and marketing procedures. Franchisees are bound by their agreements to buy supplies only from the company. Essentially, the franchisor sells products and his business management skills through a network of restaurants in which franchisees copy the format of company-owned units. The franchise system is illustrated in Figure G, where arrowheads show the direction of sales. Nothing in the franchise agreement causes a franchisee to give up his freedom to choose whether or not to supply a particular customer.

The franchisor provides eight-weeks initial training for the franchisee at an established restaurant. This is followed by continuing training support for both the franchisee and his staff. The franchisee must meet the travel and subsistence costs of trainees.

Advertising expenditures are divided on the basis that the franchisee has responsibility for his local

efforts. Sponsorship advertising is undertaken by Pizza Express on a discretionary basis.

Pizza Express provides no financial help for intending franchisees. The ability of an individual to raise funds from independent sources is regarded as an important part of the selection process. The company does direct franchisees to financial packages offered by the main commercial banks; particularly those from The National Westminster Bank and from The Midland Bank.

Excluding property acquisition fees, which would amount to £100,000 it costs £100,000 to £120,000 to start up a Pizza Express restaurant. Of this sum, shop-fitting and design services make up roughly 50%, and around 25% pays the initial lump-sum franchise fee and various professional charges. Expenditures in these two areas represent non-recoverable costs should the franchisee wish to leave the business given that property leases always belong to the franchisor. They are sunk costs which, given their size, will encourage commitment to his restaurant's success on the part of the franchisee. Remaining equipment costs would be substantially recoverable on second-hand markets. The franchisor's projection of costs and returns for a restaurant is given as Appendix G.

3. Contract

3(i) The Franchise Agreement

Pizza Express uses a detailed and extensive Franchise Agreement which is normally issued in conjunction with a property underlease. The main Agreement runs to 31 pages and has a very legalistic format. Its appearance does not tally with Mr. Dell's statement to me that "We would like

to tear up the contract but unfortunately it is a necessity". The Agreement is not a nominal document.

The presence in the Agreement of a requirement that property leases must be taken through the franchisor is unusual. It is more usual for an unwritten understanding to develop in this area. The device may help franchisees to obtain premises but is not aimed at this. Mr. Dell states that early agreements did not contain the condition which need not be made compulsory just to give help. The head lease, along with other devices, can perform three functions for the franchisor. First, it can keep a site in his possession should the franchisee leave the business: thus preserving business goodwill as an asset for the franchisor. Secondly, it can be an instrument for extracting any economic rent accruing to the franchisee: the franchisor can increase his profits by increasing the commercial rent attached to the lease when it comes up for renewal. Other devices also have these functions: for example, professional limitation clauses prevent an ex-franchisee from competing for a period following his exit from the business, and tied-in sales can extract any economic rent.

Finally, where there is a large sunk investment by the franchisee, an head lease can increase his commitment. In the case of a Pizza Express franchisee, large expenditures on restaurant design are made. If he owned the freehold on the unit, some of these costs would not be sunk as the designs might be incorporated into another business. Note that the franchisor could minimise the franchisee's commitment by making the sunk investment and then leasing the fully designed unit to him.

There now follows a simple account of the Agreement. A copy of this is available for inspection should this be required.

The Agreement grants the franchisee the right to use the trade name, operating procedures and accounting methods of Pizza Express. The term for which it is to run is specified separately but is usually 10 years. It is renewable for a further 10 years, this renewal length being written into the Agreement. A renewal fee of not more than 10% of the then current initial fee may be charged.

The franchisor undertakes to supply training and advice, assistance at the launch of the restaurant, and design specifications. He will pass on any results from research activities. Furthermore, Pizza Express is to specify suppliers for fittings and for promotional material.

The franchisee agrees to follow laid-down procedures, to pay a separately specified initial lump-sum franchise fee (currently £12,500) and to pay a 4% royalty on sales turnover excluding VAT. All charges levied by the franchisor carry VAT which may be reclaimed by the franchisee. In an attached schedule, the franchisee further agrees to use an architect approved by the franchisor for design of his restaurant, to present staff for training, to buy only the tied-in products, to stick to a standard menu, and to register a weekly sales report with the franchisor. He undertakes to run no separate Pizza restaurant within two-mile radius of any Pizza Express unit, during the term of the Agreement and for a further two years.

The franchisee further agrees to purchase employers-liability and public-liability insurance to the value of £250,000 cover, and to indemnify the franchisor against claims arising at the franchisee's restaurant.

There is a provision in the Agreement for a 0.5% levy on the franchisee's turnover to be paid to a centralised advertising fund. This has not yet been enforced (1987). The franchisor has the right to vary the terms of this with the approval of affected franchisees, for individual variations, or with majority consent if all are to be affected.

The franchise may be sold with the franchisor's consent. The franchisor has first refusal on the offer for sale. Any disputes over valuation are to be settled by an arbiter who is a Chartered Surveyor, with his fee being equally divided between the parties. If the franchise is sold to a third party, the assignee must pay Pizza Express an unspecified "current investigation fee". The franchise is inheritable on similar terms, with a beneficiary being treated like a purchaser. However, a manager will be provided for six months at cost to help a beneficiary, if necessary. If a beneficiary has not taken on the franchise within eight months of the death of his benefactor, Pizza Express can terminate the Agreement.

Termination of the Agreement may occur whenever one party breaches a condition. In such a case, 30-days notice must be given during which the fault may be corrected with no further penalty. However, Pizza Express can terminate without notice if the franchisee becomes insolvent, if he is convicted of a serious criminal offence, or if the ownership of his business changes without the franchisor's approval.

In the event of termination, the franchisee must return all manuals and remove all trade-marked items from his restaurant. The franchisor can choose whether to buy back fixtures and fittings attached to the unit, at prices to be agreed at the time.

Interest is payable at an annual rate 5% above Midland Bank base rate on any overdue payments to the franchisor.

The franchisee may sell meals at prices which are below but not above those recommended by the franchisor.

There are two technical conditions: each clause is severable, and non-exercise of a right by the franchisor does not constitute its waiver. There are no conditions allocating a territory to the franchisee. The need for secrecy is only covered indirectly by the franchisee's undertakings to protect trade marks. Finally, there are no compulsory arbitration clauses other than the one concerning valuation of the franchise.

3(ii) Implicit aspects of the contract

Mr. Dell believes that there are two implicit aspects of the contract which are important. The first of these has already been touched on above: the requirement in the Agreement for a contribution towards the franchisor's advertising costs from the franchisee equal to 0.5% of turnover is not enforced. Instead, the franchisor pays all of his costs and makes discretionary expenditures. The decision not to enforce is an understanding backed by market governance. It must be worth collecting the contribution which would amount to around £100,000 at current turnover levels. The franchisor probably feels that to do so would discourage the recruitment of franchisees. Mr. Dell cannot give a precise reason for the practice.

The second implicit aspect of the contract concerns the sales territory awarded to each restaurant. Nothing is written in the Agreement about this, no doubt due to worries about contravening legislation on restrictive

trade practices. In practice, there is an understanding that an existing franchisee will always be offered first refusal on a new site which is likely to encroach on his market. There is much room for franchisor discretion in interpreting this understanding. Its value to the franchisor arises from market conditions: franchisees must be reassured in this respect or else recruitment may suffer.

3(iii) Enforcement and monitoring

Mr. Dell states that Pizza Express tries to build a good management relationship based on trust and avoids quoting clauses of the Agreement to franchisees. I was told that "Waving the contract about would end the trust". Pizza Express is well aware that a franchisor cannot afford to gain a reputation for being heavy handed over his interpretation of the Agreement. Termination is therefore regarded as a last resort in settling any dispute. Failure of a franchisee for any reason would be likely to adversely affect recruitment.

Franchisees report their sales turnover each week. Honest reporting is encouraged by the requirement for them to buy all supplies from Pizza Express (unless the company cannot supply an item). The company has a good idea of how much turnover will be generated from a given input of its products. A centralised complaints system means that a franchisee runs the risk that a complaint would alert the franchisor to a bootlegged sale. Given his very large investment, which he is unlikely to wish to jeopardise, a franchisee should be less inclined towards fraudulent practices compared with an employed manager. Honest practices within the restaurant will be policed by the franchisee who has an incentive to monitor his own staff as it is he who is the residual claimant.

Standards of presentation and service are checked by Pizza Express management at roughly monthly intervals and through the medium of surprise visits. A checklist is used to ensure that the correct items are on menus or in refrigerators, and that cleanliness is achieved throughout a unit.

Mr. Dell claims that the franchise system does not generate many serious disputes but accepts that there are occasional "gripes". An example of a gripe would be when a franchisee might not wish to serve capuccino coffee although it is policy to do so. Mr. Dell can cite only one serious dispute which arose when a franchisee wanted to design his restaurant on the cheap. This case led to the only termination of an Agreement in the history of the company.

No franchisee has left the system either by not renewing an agreement or by selling out.

4. Why franchise?

Pizza Express originally began to franchise in 1972 as a means of retaining a restaurant manager who wished to set up his own business. Subsequent experience with the system showed that it fulfilled a need. Whilst there are 12 company-owned units in Central London, most recent expansion has been through the creation of franchises. It is notable that the company-owned restaurants are geographically concentrated. Over longer distances detailed supervision is avoided by using franchising. However, Mr. Dell does not rule out opening further company-owned units: each case would be considered individually.

Mr. Dell believes that Pizza Express benefits from franchisee entrepreneurship at the local level.

Franchisees would be more likely to make efforts to drum up business compared with company managers. Mr. Dell also feels that honestly problems are less worrying in a franchise system, for the reasons which I discuss.

The franchisor also perceives capital-raising advantages to franchising although arguments of this kind do not bear close scrutiny. Drawing in outside funds need not require investors to participate in the management of restaurants, unless they set this as a condition of making an investment.

Mr. Dell believes that the main advantages to franchisees of belonging to the system is the chance to trade under the brand name. Apart from this, the tied-in sales from the company warehouse give one-stop shopping possibilities which should save transactions costs for franchisees.

5. Fees and returns

The initial lump-sum franchise fee of £12,500 (in 1987) is described by Mr. Dell as embodying a 20% profit element. This is regarded as small. Otherwise the fee is spent on launch promotion and on administering the start of the new franchise.

Mr. Dell states that the mark up on tied-in sales is very small: only normal business returns are made on them. Interestingly, the same transfer prices are used between the warehouse and company-owned restaurants. This practice is consistent with rational transfer pricing but does not mean that profits from the retail end of the business are not being shifted back to the warehouse. The comparison which matters is with market prices. If franchisees could buy more cheaply from elsewhere, then either resources are wasted buying from genuinely dearer

company sources or else profits are being shifted. A further option is that franchisees cannot buy more cheaply and the mark up on the franchisor's goods is simply a return to his procurement skills. A final option is that they cannot buy more cheaply and, as claimed, the franchisor's mark up is negligible; so that he simply operates his sales as a service for franchisees. In this case, the restrictions on purchasing may operate simply to control quality. It could even be that the franchisee is made to suffer a little inefficiency over costs in order to control quality.

The sales royalty levied at 4% on turnover is not an high proportion but accounts for the main source of the franchisor's revenue, according to Mr. Dell. This is set in the renewable Agreement and could not be varied as a means of extracting any economic rent appearing at the retail end of the business.

The company aims to pass on the commercial rents for property leases at cost with the addition of an administrative charge of 5%. The charge could be varied at rent-review periods which are written into lease agreements; these are normally at five-year intervals.

Pizza Express has lease charges, the initial fee, the royalty level and the transfer prices of tied-in sales as devices which it could set to extract any economic rent which might be present at the retail end of the business. However, once agreements are in place, only the transfer prices of products and lease charges can be varied.

Sales targets are set for franchisees and depend on the company's view of growth prospects for a particular market. There is no uniform growth rate which is expected of all units.

Mr. Dell believes that profits are well above the average for the restaurant trade, both for Pizza Express and for franchisees. No figures were quoted. He argues that this is reflected in the high demand for franchises: he receives 40 enquiries a week and has a problem finding sites.

Franchisee G₁

G₁ began as a Pizza Express franchisee in 1986 in partnership with XXXX. I interviewed G₁ in his restaurant which is based at XXXX in London. The restaurant seats around 40 customers and employs four people not counting the franchisees. G₁ was previously self-employed as an entertainment promoter and XXXX continues to be an accountant. The restaurant was started after the two franchisees saw a company-owned unit, heard of the franchise arrangements, and pursued their enquiries with Pizza Express.

G₁ was the only franchisee whom the company encouraged me to interview.

All products are bought from Pizza Express. This is not always agreeable to G₁ who believes that he could purchase equivalent products more cheaply from elsewhere. There have been some minor disputes over this. G₁ has responded to the franchisor's exhortation and does not try to use other suppliers as he believes that he must maintain a good relationship. Interestingly, I was told that the only franchisee who is some distance from London, the one for Jersey, is given greater freedom over his supplies. This suggests that standards can be achieved with outside supplies. However, tying down inputs may be a cheap way for the franchisor to encourage proper standards. If G₁ could save on input costs and still meet objective criteria for recipes and presentation, as he

claims, then the franchisor is controlling standards at the franchisee's cost. It should be noted that some monitoring would need to be added to the existing system if purchasing freedom were given to franchisees. This would not be costless and could result in greater fees to franchisees compared with any higher prices currently faced: it still does not follow that the franchisor must be extracting economic rent.

G₁ sees his obligations in the franchise system as paying his fee and maintaining standards in his restaurant. He expects Pizza Express to provide general support and training, and to monitor the system to prevent poor units arising to tarnish the brand image. Overall, the franchisor "Was very helpful at the start although a bit hidebound". G₁ finds that innovations which he proposes are not drawn on to the extent he would like to see. However, he experiences no onerous monitoring or regular quotation of his Agreement.

The franchisee sees the brand name of Pizza Express as an important advantage to his business. He believes that people do set out for an evening out intending to finish up at their neighbouring Pizza Express restaurant. In addition to this, he feels that his risks are reduced by being a franchised business. G₁ is aware that the failure rate for franchised new businesses is lower than for new businesses in general. In his particular case, Pizza Express has made it clear that they would buy him out rather than see his unit close: the franchisor believes there is a sound prospect for the business in XXXX and would not wish to a publicised failure if the franchisee could not produce good results.

G₁ confirms the structural details of the franchise system which were reported by Mr. Dell. He is convinced that the initial fee does contain a substantial profit

element because no major cost items or services were provided at the start-up by Pizza Express. Nevertheless, G₁ is happy with his profits, especially as his restaurant is only recently established. He hopes in time to add a further unit.

My observations were of a quality restaurant which is becoming established in the village setting of XXXX.

Company Outlet

I was able to compare the day-to-day operation of the company-owned restaurant in Wardour Street, where I met Mr. Dell, with G₁'s franchise in XXXX. Whilst the Wardour Street and XXXX restaurants differ slightly in their individual design this is to no greater extent than would be expected to take account of the features of local markets. The external appearance and the interior decoration is similar for both. XXXX aims for more of a village restaurant image than Wardour Street. Menus, staffing levels and procedures are identical in both cases.

Mr. Dell states that company-owned restaurants automatically achieve the laid-down operating standards, once managers have applied company procedures. Franchises require more delicate treatment as they are self-employed businessmen. They must be kept feeling that it is always worth fitting in with the franchise system. Some problems of monitoring like checking on honest reporting of results and ensuring sufficient running, recede with the franchise system. However, maintaining an harmonious long-term relationship, largely through assisting an independent businessman to make profits, adds an important extra dimension to management tasks.

Summary

Pizza Express runs a restaurant chain comprising mostly franchisees with some company-owned restaurants. Franchisees follow a very carefully controlled business plan in which they must use company-approved restaurant designs, abide by a standard menu, purchase tied-in products and take the property lease through Pizza Express.

The franchisee begins with a number of instruments through which he may transfer revenue from franchisees to himself. These are the initial lump-sum fee, the royalty, transfer prices for tied-in products, and lease-management charges. In the longer run only the lease changes and transfer prices remain free to vary. The franchisee whom I interviewed expresses no concern over his lease, but does believe that profits were made by Pizza Express on the initial fee and believes he could buy products more cheaply elsewhere. It is possible that the dearer products are justified as a simple but necessary monitoring system; even so, franchisee profits are affected.

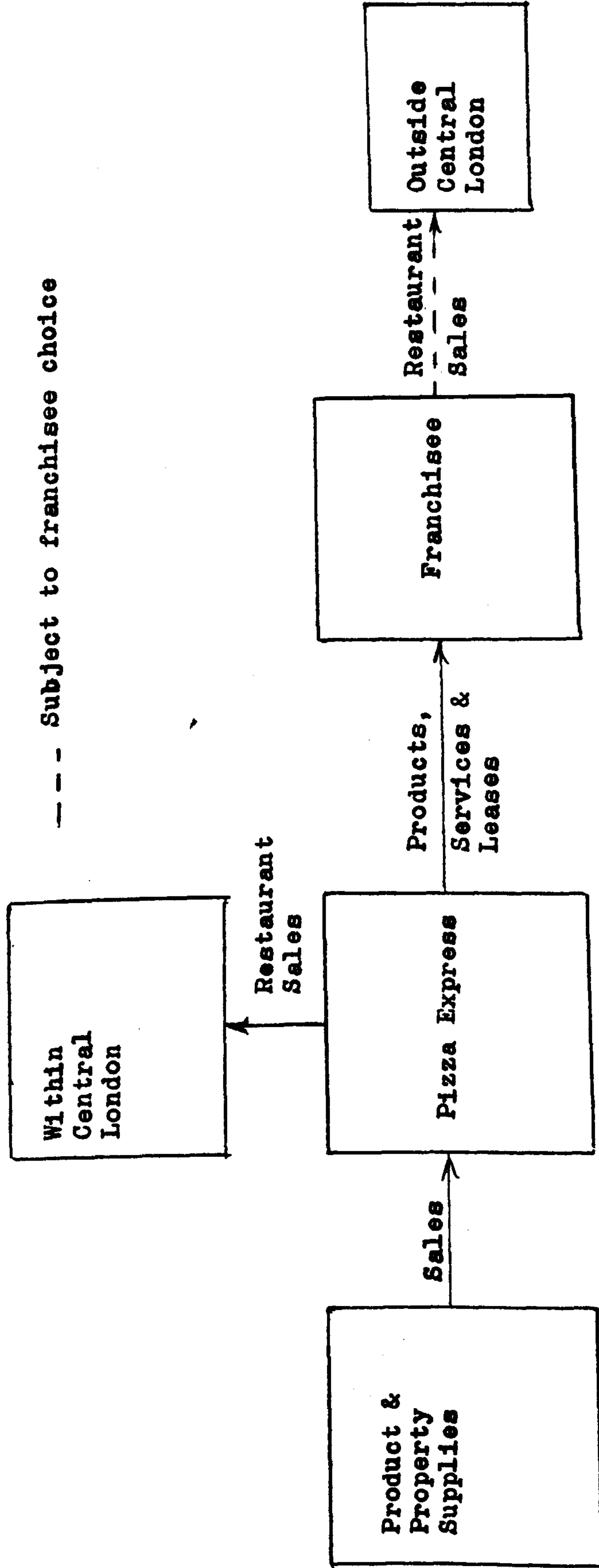


Figure G Pizza Express Franchise System

PIZZA EXPRESS

CAPITAL COST

The costs of establishing a PizzaExpress outlet are naturally subject to variations. The following costs are a general guide to the cost of setting up a 60 to 80 seater restaurant.

| | £ | £ |
|--|--------|--------|
| 1 EQUIPMENT | 16,000 | 18,000 |
| 2 FITTINGS (neon sign, flooring, lighting, paintings, blinds). | 10,000 | 12,500 |
| 3 SUNDRY (Franchise purchase price, working capital, legal and architectural fees). | 27,000 | 30,500 |
| | 53,000 | 60,000 |
| 4 SHOPFITTING AND DECORATION — in addition to the above, capital sums will be required for shopfitting and decoration. This will vary from site to site, depending on the extent of the work that has to be done. Due to this no accurate cost can be projected but it is unlikely that this type of work will cost less than £45,000 to £60,000 on even the most suitable site. | | |
| 5 PROPERTY ACQUISITION COSTS — no allowance is made in the above for leasehold premium payment which may be required to obtain a suitable site. | | |
| 6 TOTAL CAPITAL COSTS — the total capital investment, exclusive of property acquisition, is likely to be in the range of £98,000 to £120,000. We would require a prospective franchisee to have a minimum of 50% of the total estimated investment available in liquid assets. | | |

FEES

The franchisee's investment covers the full capital cost of setting up his outlet. Nevertheless, there is investment required by PizzaExpress in the form of service and administrative facilities and design and promotion.

The fees are as follows:

£12,500 + VAT initial licence fee, which covers the franchise purchase price;

a fee of 4% of the franchise's gross sales (exclusive of VAT) to be paid monthly to the company;

a contribution towards the company's advertising and promotional fund equal to one half of one per cent of the gross sales.

PROFITABILITY

The main appeal of a franchise is, of course, its profitability and we are naturally just as concerned with achieving a good return as are our franchisees; it is the goal towards which we both work.

At the lower levels of turnover the franchise is best managed by the franchisee himself. As 'owner-operator', he is in the best position to control costs and administration. What is more, he can absorb a substantial percentage of the wages bill as a result of his own efforts.

At higher levels of turnover, however, although it is equally suited to the owner-operator, franchising becomes of greater interest to the investor who is prepared to delegate the outlet to a full time manager — an option which may become more attractive as the turnover of a particular outlet grows.

No two outlets perform identically; but all conform to a pattern once a profitable turnover has been achieved. Here is a breakdown of costs and profit as percentages of turnover:

| | |
|--|-----|
| PURCHASES (food, drinks) | 32% |
| WAGES (staff & management) | 30% |
| ESTABLISHMENT COSTS (Lighting, heating, repairs & maintenance) | 4½% |
| INDIRECT COSTS (hire of equipment, cleaning materials, paper, sundry expenses) | 4½% |
| RENT & RATES | 10% |
| FRANCHISE FEE | 4% |
| NET PROFIT | 15% |

Some of these costs are capable of reduction, especially wages, the control of which is particularly important at lower levels of turnover.

Appendix G

Pizza Express Projections

CASE H BALLY GROUP (UK), LIMITED

The franchisor1. Background

Bally is an established company dating back to 1857 in Switzerland and to 1887 in London. The company manufactures shoes in addition to acting as a wholesaler and as a retailer. In the UK, manufacturing began in the 1930s as a means of circumventing restrictions on importing from the Continent. Since 1977, Bally has been part of the Oerlikon-Buhrle holding group, a Swiss public company with diverse manufacturing interests. In addition to Bally shoe factories, there are specialised contracts with separately owned Italian factories for supplies of shoes. Around 50% of all shoes sold by Bally in the UK come from company factories located either in the UK or on the Continent.

In the UK, Bally became active in franchising in 1982 as part of a strategy meant to improve the company's profitability. In 1975, Bally had made losses and this led to management changes. By 1979, the new management included individuals with experience of franchising. In addition, it was diagnosed that the company was too dependent on open-market sales of shoes to independent retailers: there were then just six or so Bally shops mostly in the West End of London. In recent years, brand-name shops have developed in footwear retailing and are considered to be the quality end of the market. Bally wished to expand its chain and to develop what was felt to be a quality-brand image. Given the expertise in franchising of some managers, the creation of a franchise system became an important aspect of expansion.

Bally continues to operate larger shops with turnover greater than £500,000 as company-owned units but prefers to franchise medium-sized shops or shops-within-shops. Franchising is used outside of the London area. A minimum turnover of £150,000 a year is needed to make a specialist-brand shop viable in the provinces. Such a shop is unlikely to achieve a turnover greater than £500,000. Where local population is not expected to support a sufficient level of sales, Bally may enter into contracts for specialised displays within shoe shops. Apart from sales to the West End shops, to franchises and through the contracts, Bally sells to any retailer who wishes to mix the shoes into his stock.

There are currently 40 company-owned shops and 11 franchises. Bally's UK annual sales amount to £40 million, of which 40% are through company-owned shops, 10% are through franchises and the rest are sales to independent retailers. Recent company policy has been to enhance retailing capacity and to increase the relative size of the franchise network.

The product range principally comprises modern, lightweight shoes with classic rather than high-fashion features. There is a modest fashion element added to the range sold in company shops. The stocks held by independent retailers cover a smaller range of shoes. In addition to shoes, company-owned and franchised shops carry accessories like handbags and ladies' hosiery.

Bally does not limit franchisees to one shop. A dramatic instance of multiple franchising is the case of H, which is discussed below. He has six Bally franchises located in the north of England and in xxxx. Fractional franchises do not exist in that no franchisee operates a unit as part of his larger business. However, sites do

not always stand alone and often they are shops-within-shops in department stores.

The franchisor is a member of the British Franchise Association. There is an active franchisee association, although not all franchisees belong to this.

2. Nature of the franchise

I interviewed Mr. Philip Peters, Franchise Development Manager for Bally (UK), at the company's London headquarters. He believes that franchisees' obligations are to achieve high levels of sales and to maintain the Bally specialised image of their shops. In return, Bally should give them full management and market support, and should monitor the chain to prevent the appearance of any poor shops.

When a franchise is started up, Bally will always provide a shopfront and all moveable shopfittings; the franchisee pays for decorating, fixed signs, alterations and carpets. In addition, the franchisee must purchase an initial stock of shoes which costs about £60,000. On top of this, there may be a premium to pay to obtain a lease, which is then always held as an underlease through Bally. In total, it costs around £120,000 to start up a typical franchised shop. The sort of shopfitting paid for by a franchisee is leasehold improvement and represents a sunk cost if the landlord will not allow transfer of the site to another user who values the improvements. Stock can always be resold at market value, which, allowing for odd lines, might be 80% of its cost. Any premium on the lease or unexpired portion of a commercial rent paid is also sunk expenditure if a landlord will not allow transfer. The underlease arrangement leaves Bally with control over the disposal of the business premises, should a franchisee wish to close down. Consequently, around £70,000 of the

starting costs may represent sunk expenditure by a franchisee, which provides him with a powerful incentive to make his business succeed. Much of the initial investment is transformed into highly specific assets at the start of a franchise.

There is no initial lump-sum franchise fee, although a franchisee is expected to reimburse Bally for any professional charges which are incurred during the start up. Bally does not offer financial help to franchisees, other than by providing moveable shop fittings. The company can direct franchisees to financial packages which are offered by the major commercial banks.

Bally offers a full business-format franchise with operating systems covering shop management, stock-keeping and sales. A manual has not yet been produced although it is detailed in the Franchise Agreement.

The franchisee is expected to purchase almost all of his shoe stock and most of his accessories from Bally. Whilst there is nothing in the Franchise Agreement to limit the franchisee's normal freedom to choose whether to serve a particular customer, he acts very much as a channel for selling the franchisor's product. The only real exceptions to this are certain accessories like ladies' hosiery and the Barker range of traditional shoes. It is understood that hosiery may be sold by franchisees even though its source sometimes lies outside of the company. Purchases from Barker, which plug a gap in the Bally product range, are allowed for in the agreement. The Bally franchise system is illustrated in Figure H, where arrowheads show the direction of sales.

3. Contract

3(i) The Agreement

Bally uses an extensive Franchise Agreement which runs to 45 pages and contains 36 full clauses. The Agreement appears to attempt (the impossible) to cover all eventualities. Yet Mr Peters proudly told me that Bally ran the franchise system for one year without using any agreement. There now follows a simplified outline of the main clauses. A copy of the Agreement is available for inspection should this be required.

The Agreement begins by defining the Bally products to be footwear and related accessories. The franchise is granted for 26 years in conjunction with an underlease arrangement, where Bally acts as the franchisee's superior lessee. The franchisee must take his premises through Bally and this condition acts to provide control of the property for the franchisor should the franchisee wish to close his business: the franchisee's investment in shop fittings can be made completely specific to his Bally franchise. In addition, five-yearly rent reviews which are written into the sub-lease could be used, along with the initial setting of the property changes, to extract economic rent from the franchisee. Mr. Peters claims that franchisees would not obtain leases fully in their own name on high-street sites.

The franchise may be renewed at no extra cost to the franchisee, provided Bally is able to obtain a renewal of the full lease on the premises.

The franchisee undertakes to trade under the name 'Bally at ...' but not to use the Bally name in his own registered company name. All goodwill generated for the network is to be held in trust for Bally by the

franchisee. Only the Bally range of goods should be sold on the premises, with the exception of Barker shoes which may also be sold. The hours of opening must be those normal for a locality. The franchisee may run no other competing business without the franchisor's consent. The premises must be kept in good repair. The franchisee must make any improvements to the shop which are implied by the designs supplied by the franchisor free of charge at the start of business.

The franchisee also undertakes to complete Bally's initial training program along with his staff. He will pay the travel and subsistence costs incurred except for courses covering stock management, public relations, shop layout, staff training and sales promotion, where the franchisor picks up the entire bill. No staff are to be enticed from the franchisor; nor may anyone be employed by a franchisee who has worked anywhere within the chain over the preceding year.

Employer-liability, public-liability and key-man insurance must be taken out by the franchisee. This last must protect the business against loss of the services of senior managers: one franchisee has himself insured for £500,000 in this respect. Also the franchisor must be completely indemnified against accidents affecting staff or members of the public in the shop.

The franchisee agrees to share equally the cost of an Epsom computer system which is used for stock control in the shop. Sales and stock information must be supplied to the franchisor when he requests this. Sales are to be reported each week. All charge cards which are approved by Bally should be honoured by the franchisee. Bills from the franchisor are to be settled promptly. Interest at 3% more than Barclay's Bank base rate is to be charged on overdue payments.

The franchisee agrees to pay a 3% royalty on his sales turnover, excluding VAT and any refunds to customers. This is to be paid monthly. He also accepts that Bally may set a sales target for him which will be at least equal to his previous year's sales increased by the change in the Retail Price Index for that year. All payments to Bally will incur VAT which the franchisee can reclaim from the tax authorities.

A professional-limitation clause established that the franchisee will not compete for one year within his old market area should he leave the system. The franchisee also agrees not to employ his old employees or the employees of other franchisees during this period.

The franchisee undertakes to respect Bally's intellectual property rights in the methods of doing business and not to divulge these to others.

The franchisor's undertakings are of a more general kind in the Agreement. Bally agrees to provide the franchisee with paperwork systems for invoicing customers. Also a shop front and all moveable shop fittings will be provided free of charge at the start of the franchise. In addition, Bally agrees to be available for reasonable amounts of consultation over running the franchised business and to supply a manual giving operations guidance.

Bally gives franchisees a sales territory by covenanting to locate no retail shop within a market area which is specified in a schedule attached to the Agreement. In addition, no contracts for specialised displays in independent shops will be entered into within the area. No set market area is used: this varies from town to town according to population characteristics.

However, sales for general stocks at independent shops are not ruled out.

The franchisor undertakes to promote the launch of a franchised shop by discretionary amounts of local advertising. However, all advertisements which franchisees intend to use must first be vetted by Bally. The lower of 50% of his local advertising costs or 1% of his wholesale turnover will be reimbursed to the franchisee.

The franchise may be sold with Bally's approval. The franchisor has first refusal on the business which is taken to include fixtures and goodwill. There is a formula for valuing stock and a clause requiring compulsory arbitration if Bally disagrees with a franchisee over the worth of a business. Arbitration is to be by a Chartered Surveyor, with his fees being equally divided between the parties. Bally is not obliged simply to match any market price which may be bid for a franchise in exercising the right of first refusal. The underlease would be surrendered to the franchisor when the franchise changes hands; here too a Chartered Surveyor must settle any dispute over valuation.

If the franchisee becomes seriously incapacitated, Bally can impose a manager on the franchisee. If there is no recovery within 12-months of the manager taking over, Bally can insist that the business is sold under the usual conditions. Similarly, if the franchisee dies, after a three-month period during which his beneficiaries can decide whether to run the business themselves and during which a manager may be supplied, Bally can insist on sale under the normal conditions. No mention is made in the Agreement of the cost of such management assistance.

The franchisor can terminate the Agreement with three-months notice if there is any breach of contract other than failure to reach the agreed minimum sales turnover. This also applies if the franchisee becomes insolvent, if he suspends payments, closes or threatens to close the business, if the ownership structure of the franchisee's business changes in an unacceptable manner, or if the underlease expires. In these cases, the franchisee has 30 days in which to correct matters and cancel the notice. If the minimum turnover is not achieved, Bally can give the franchisee 12-months notice.

In the event of termination, the franchisee must cease business, surrender the underlease, vacate the premises, return the manual and trade-marked display items, and transfer telephone numbers at Bally's discretion. This last requirement appears to serve no practical purpose in this case and is not doubt borrowed from other agreements where businesses take telephone orders and the retention of a telephone number implies retention of customers.

Finally, there are a number of technical conditions in the Agreement: no partnership or agency relationship is implied between the parties; the Agreement is held to be the entire contract; non-exercise of the franchisor's rights does not constitute their waiver; clauses are severable; and the Agreement is to be governed by English Law.

The Agreement has no striking omissions but is noticeable for verbosity. One important clause in the copy given to me, giving Bally the right to revise the terms, is crossed out with the words "An unfair term" written in the margin. There are other handwritten alterations throughout the document suggesting that it is under revision.

The franchisee is completely free to follow his own pricing policy.

3(ii) Implicit aspects of the contract

Mr. Peters believes that there are two examples of implicit aspects of the contract between franchisor and franchisee which are important in practice. These are business understandings which are governed by the long-term value of the relationship to both parties. It is possible to easily observe further implicit aspects.

First, Mr. Peters points out that franchisees carry small stocks of some accessories like ladies' hosiery. These are items not well provided for in company supply lines but which help franchisees in building their businesses. It is too small a matter for the franchisor to wish to disrupt good relations with franchisees over it. Secondly, it is understood that franchisees will pay the franchisor's professional charges incurred in starting up the franchise shop. This is not contractually specified but is worth accepting by a franchisee; his acceptance of this is just part of his cost of obtaining a franchise.

It may also be observed that the transfer prices of products are not set in the Agreement even though these are a means through which economic rent can be extracted from franchisees. The market place sets definite limits on such extraction: in the long run, recruitment of franchisees would be adversely affected if prices rose well above comparable market prices.

A number of franchisees have expectations that property rents should be passed on at cost, that any premium on the lease should be returned to the franchisee if his lease is surrendered, and that Bally stands ready to buy back any franchise which is in danger of failing. As far as the

lease matters are concerned, it is true that recruitment of franchisees could be reduced if Bally developed a reputation for making large profits on leases. Bally's incentive to buy back arises because of the adverse publicity which would surround cases of failure. These matters are discussed further below.

Finally, franchisees accept that they may not sell the more fashion-orientated part of the range.

Mr. Peters points out that Bally had a network of seven franchises before an Agreement was drawn up. For one year, trading was on the basis of understandings and exchange of letter.

3(iii) Enforcement and monitoring

Mr. Peters' claims that Bally would only quote the Agreement to franchisees as a last resort. The Company prefers to proceed by active management contact with franchisees and by exhortation in cases of disagreement over issues or outcomes. The avoidance of detailed citation of the Agreement is confirmed by franchisees.

The franchisor monitors sales on the basis of weekly reports submitted by franchisees. In time, Bally hopes to use the Epsom stock system for computerised point-of-sales monitoring. Product inputs are observed through tied-in sales to franchisees: these also act as a check on honest reporting of sales.

The franchise system encourages honest reporting of sales by giving franchisees a profit incentive to monitor their own employees. The high sunk investment at the start also gives a franchisee a lot to risk if he attempts fraud, relative to an employed manager. Bally can concentrate upon monitoring the franchisee leaving the

branch staff as his responsibility. The franchisee only benefits from saving a small royalty payment through hiding a sale, whereas an employee benefits from the entire purchase price. Anyway, as long as Bally shoes cannot be bought from elsewhere, the franchisee cannot buy shoes from outside of the system without losing any brand advantage that he enjoys: this condition is broadly satisfied.

There are four area supervisors for the franchise network. These visit franchisees about once a month. The costs of this part of the system are thought to be acceptable by Mr. Philips. In time, Bally hopes to use the same area management structure for both franchised and company shops. A mystery-buyer technique, in which Bally employees visit franchised shops and study service levels as purchases are made has been used.

At the time of my interview with Mr. Peters (March 1987) he was only aware of minor trading gripes within the franchise system. In particular, some franchisees had expressed dissatisfaction with parts of the product range.

Mr. Peters is concerned that one franchisee, H₁ has developed a sub-chain of six shops. There is a worry that Bally might be vulnerable to take-it-or-leave-it bargaining strategies over prices or terms of sale.

4. Why franchise

Mr. Peters believes that Bally confers a major brand-name advantage on a franchisee. The footwear is regarded as an high-quality product at least comparable to shoes produced by Clarks or Kay Shoes. The franchisor knows that the franchise package enables a small businessman to benefit from trading as part of a specialist chain. In addition, Mr. Peters states that the franchise

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arrangements embody useful stock-control systems and beneficial purchasing arrangements for a franchisee. Finally, he thinks it is most unlikely that high-street leases would be obtained without Bally's involvement.

The franchisor mainly benefits from franchising by being able to call on the entrepreneurial skills of franchisees, according to Mr. Peters. Whilst it is true that both company-owned and franchised shops preserve Bally's brand image, franchisees have less demand for management involvement in their local business affairs compared with company managers. Franchising is seen as allowing greater specialisation with the franchisor concentrating on property acquisition, manufacture, marketing and purchasing, and the franchisee becoming increasingly skilled in local operations management. Mr. Peters points out that the company particularly favours franchising in the provinces where long lines of communication make direct management more costly. Bally's own shops are concentrated in areas which are near to hand in London, where turnover is higher and can support more supervision costs, and where leases are probably too expensive for a franchisee to take on.

Lease costs could stand in the way of franchising because, if Bally had to pay for the lease, the franchisee's specialised investment could be lower and he might be less committed to the success of his business.

Mr. Peters knows that Bally could easily raise its own finance for expanding a network of shops. Capital-raising advantages are not perceived for himself by the franchisor.

5. Fees and returns

As considered above, Bally charges no initial lump-sum franchise fee and only requires franchisees to pay professional fees which Bally incurs at the start of a new franchise. A sales royalty of 3% is charged on monthly turnover, as detailed in the Agreement. Other than this, the franchisor has the transfer prices of tied-in sales and the commercial rents attached to leases as sources of business revenue. Mr. Peters states that there is a profit element for the franchisor in the transfer prices but describes this as "modest". Rebates are given on an increasing scale to franchisees for large purchases of shoes. Leases are passed on at cost, including costs incurred by the ultimate landlord in making period inspections. The royalty, transfer prices and lease charges could all be used as means to extract any economic rent arising at the retail end of the business. Once an Agreement is in place, however, only tied-in sales and commercial rent reviews could be used to redistribute profits to or from the franchisor.

Mr. Peters is satisfied that franchisees obtain good financial returns from their shops. No projections were given to me, however. He is also happy that Bally is achieving good profits from operating the franchise system.

The franchisees

1. Franchisee H₁

H₁ has developed a group of six franchised shops since being approached by Bally in the early 1980s to open the first franchise. This was started, initially as a shop-within-shop at xxxx department store, in xxxx, in 1982. H₁ had previous experience of establishing his own shoe

shops in the north of England. He had sold a number of previous businesses but retained interests in two Kay-Shoes franchises at the time of the approach by Bally. The franchises are located within department stores at xxxx, xxxx and xxxx, and as stand-alone units at xxxx, at a second xxxx site and (since 1987) at xxxx. H₁ operates his shops as "Bally at ..." in accordance with the Agreement. His business was registered as a public limited company in 1986.

xxxx has an annual sales turnover of approximately £500,000 and employs 90 people. At the end of 1986, xxxx offered £750,000 worth of shares to the public under the Business Expansion Scheme (through which investors receive personal tax relief on their investments). Part of the basis of the offer was that H₁ had options on a further 12 Bally franchises. In fact, during 1987, Bally appears to have had some second thoughts about this level of expansion of xxxx. H₁ has added two shops to his chain but these have been franchises with Kay Shoes, building on his earlier interests.

H₁ believes that he has an obligation to pay his royalty on turnover but otherwise should run his business as he sees fit. The franchisor should earn this royalty, according to H₁, by providing marketing support including product development; the aim should be to give the franchisee a range that will sell. The main advantage of belonging to the franchise network is thought to be the enhancement of H₁'s reputation with independent department stores. He believes that he could not have obtained areas of such stores for his shops-within-shop units without the benefit of Bally's name.

H₁ is somewhat critical of the Bally franchise network. He claims that business projections which are made at the start of a franchise are too optimistic. He also reports

that some advice he has received turned out to be ill judged. He once considered legal action over these matters. In general, he sees no difficulty in simultaneously pursuing a business relationship and litigation.

Other points of dissatisfaction for H₁ are advertising by the franchisor and the level of management expertise which appears to be available to him. He claims that due to the manufacturing and non-franchise retailing activities of Bally, it is difficult to identify advertising aimed at building up the sales of the franchise network. The contractual obligation for reimbursement of 1% of the franchisee's advertising costs is difficult to assess, as Bally offsets local advertising which may have originated from company-owned shops. H₁ also alleges that no franchise manual has yet been provided for his shops. This suits him as he is naturally very independently minded over operations management, but it indicates an excessively casual attitude to him.

H₁ confirms the structural details covering franchise fees, internal sales and operational arrangements which are reported by Mr. Peters. However, H₁ believes that he could have traded more profitably as an independent retailer; although it must be remembered that he could not have obtained floor space with independent department stores on his own. He alleges that sales targets are fixed on no obvious basis and are unrealistic. The transfer prices of shoes are identical for franchisees and independent retailers, according to H₁, who clearly has close knowledge of the trade. His business is profitable, and his intention to remain with Bally suggest that profits are satisfactory to him. Leases are never a point of contention.

My observations of H₁'s xxxx unit were of a busy, high-class shoe shop which fitted in with the Bally image. Customers would have no means of knowing that the outlet is franchised.

2. Franchisee H₂

H₂ established his franchised shop in 1986, having worked for 16 years in shoe retailing. His shop is a stand-alone site in a busy shopping centre. H₂ is realising a long-held ambition to run his own business, having worked previously for a retailer who stocked Bally shoes and discovering that franchises were available. He has formed a limited company with his xxxx; both work in the shop which employs a further five people. H₂'s sales turnover is approximately £150,000. Some non-Bally accessories are sold in the shops.

The xxxx shop holds stocks worth around £75,000 at any one time. H₂'s other starting costs amounted to approximately £60,000. He realises that over half of the total of £135,000 is sunk expenditure and feels that his determination to make his business succeed reflects this. He readily points out "I have everything tied up in this business", and believes that he can offer the franchisor local entrepreneurship which would be lacking in a paid manager.

H₂ believes that the Bally name is of great value. Customers regard the product as being of high quality. Also, he is able to obtain an high-street lease through Bally. On his own, he thinks he would have to locate less prominently and would have an altogether less profitable business. H₂ is impressed with the shop design and with the product range. He believes he has an obligation to maintain operating standards at least equal to those elsewhere and insists that "It is important that customers

think it is a Bally shop". The franchisor is expected to give full marketing and product support, and to respond to requests for advice.

This franchisee and his staff participated in two-weeks initial training at one of Bally's London shops. H₂ had never seen a franchise manual, however, and believes that none yet exists. 1% of his advertising costs are paid by the franchisor as specified in the Agreement. Like H₁, H₂ initially operated without an agreement. He is generally happy with the franchise arrangement and with the level of support which he receives. In time, he hopes to add a further franchise to his business.

H₂ confirms the structural details of the franchise system which Mr. Peters reports. He is happy with his business returns so far and anticipates early profits. Lease costs are not contentious: H₂ understands that commercial rents are passed on at cost. He is also aware that the transfer prices that he pays are identical to those paid by an independent retailer for Bally shoes.

This franchisee knows that there are some occasional disputes between Bally and franchisees over things like sales targets. He also knows that in 1987 Bally bought back three of the franchised shops to run as company-owned units. However, his own experience has been of plain sailing. H₂ believes that Bally will always buy back a franchise which looks like it might fail. He understands that the company cannot afford the bad publicity that shop closures would generate for the franchise system. This knowledge, borne out by recent buy-backs, would reduce the sunk part of the investment H₂ has made and could lessen his commitment to success.

My observations were of a family-run business which

fully occupied the franchisee. Customers would not know the shop was franchised unless they enquired.

3. Franchisee H:

H₃ established shops in 1985, found that their financial performance was not what he had expected, and sold them back to Bally in 1987.

The two shops employed seven people and offered a standard Bally range plus Dior ladies' hose and some shoes by Barker. The range was fully approved by Bally. The franchises were standard in every respect in relation to the structural details which Mr. Peters describes. H₃'s main complaint is that not enough management support was forthcoming from Bally. H₃ believes that his obligations were to maintain Bally standards in his shops and to respect the company's trading policy. In return, he expected full support including ready access to stocks of their better-selling shoes. When he became a franchisee, having previously been in retail management, he felt that the brand name was a good one which was also under-represented. He thought that there would probably be advantages to joining at an early stage in the development of the brand.

This franchisee, along with H₁ and H₂, also knew of no franchise manual. In addition, he had received little advertising support beyond a 50% contribution towards his own advertising costs; the franchisor's advertisements were usually for shoes only sold by company-owned shops. For training, H₃ and his staff received three-days instruction at the London shops and the Norwich factory. He describes the training as "poor".

H₃ was able to retrieve his investment when he realised that he wanted to close his shops due to their poor

performance. In accordance with the understanding which is described above (Section 3(ii)) he sold back to Bally more or less at his investment costs, including the lease premium. However, H₃ points out that valuation clauses in the Agreement virtually rule out capital gains for a franchisee. The operation of this understanding is likely to dilute franchisees' commitment to their businesses.

Like other franchisees, H₃ operated his shops for one year without a franchise agreement. His lawyer thought this to be unenforceable when it did arrive. Overall, H₃ gained the impression that Bally "Is not too concerned about franchisees". He cites as further evidence for this the failure to find new franchisees for his old shops and the establishment of a company-owned shop in Leamington Spa, a medium-sized market.

H₃ believes that the Bally franchise system can run without disputes if franchisees have a "shopkeeper mentality". However, he did have problems: his own shop displays were rejected by the company and he often felt that initiative was squashed. He confirms that leases are not points of contention between franchisor and franchisees.

Company Shops

Company Manager H₄

I interviewed H₄ in order to compare operational aspects of company-owned and franchised shops. The xxxx shop is one of those which has been sold back to Bally. H₄ was the shop manageress both when the shop was franchised and now that it is company-owned. She is in a good position to compare operational details.

The main change that H₄ reports is an increase in head-office involvement with the shop. She now sees an area manager at least once a week whereas this would have happened at roughly monthly intervals, although the franchisee would have fulfilled many of the roles now undertaken by company management. H₄ is happy to be able to call on the stocks of the other 40 company-owned shops, which is an arrangement that did not exist before.

H₄ now sells exactly the same range containing more fashion items, as is sold by the other company-owned shops. The full range sells well in xxxx and it is hard to see why franchisees are not generally permitted to sell it. H₄ and her staff of 3 enjoy sales commission in addition to their salaries. It is thought that the business is likely to achieve profitability within the next few years.

The shop's appearance remains unchanged from its franchised days.

Summary

Bally has established a network of franchised shops over recent years as part of its expansion into retailing. This network is used to sell a slightly restricted range of shoes mainly outside of London. There appears to be little logic to the decision to restrict the range; although it may act to preserve a separate identity for company-owned shops. In general, Bally has sought individuals with retail shoe-trade experience to act as franchisees.

The franchisor has a number of instruments available to move profit from franchises shops to Bally central funds. However, once agreements have been set, only the transfer process of tied-in products and rent reviews can be used

to vary the distribution of returns. Franchisees are not anxious over the use of superior-lessee arrangements as devices to extract economic rent. Transfer of tied-in products occurs at market prices, according to franchisees. Franchisees do not feel vulnerable on these points.

Franchisees report a number of points of dissatisfaction with the system. Bally is perceived as having a casual attitude towards franchisees: agreements have been slow to arrive and no manual has been distributed to date (1987). Three franchisees have left and sold back their franchises to Bally.

It may be that the franchisor has been conducting an experiment having observed the success of franchising elsewhere. Bally may be reconsidering a decision to build up the franchise network, given that promised expansion for a major franchisee has not been forthcoming and that bought-back shops have been kept under company operation. If Bally is reconsidering, it would suggest that the lower management costs attached to franchising are too small a benefit in this case. Franchisees with little support may be unable to generate adequate sales to justify the system.

The franchisees initial expenditures in starting up contain an high proportion of expenditures which either are sunk by their nature or can be made sunk by the franchisor. The franchisor's practice of readily buying back weak shops dilutes the potential power of these sunk costs as devices to increase the franchisee's commitment to the success of his business.

CASE I NATIONWIDE INVESTIGATIONS LIMITED

The Franchisor1. Background

Nationwide Investigations was established in 1963 by Stewart Withers in partnership with his brother. The partnership broke up in 1975 over the question of whether to begin franchising the business. Mr. Withers formed the present version of the company in 1975 and started franchising in 1978. There are now 10 franchisees covering most major English cities. Each franchise employs two people on average. With the franchisor's 20 direct employees, this means that around 40 people are employed in the Nationwide network. It is a small-scale business which often deals with work requiring great discretion.

The work is very specialised and consists of debt collection, divorce cases where large settlements are involved and it is worth arguing over blame, and crime detection in cases where public prosecution would be undesirable for the victim. An example of the type of crime which needs very careful handling is theft within a bank by one of its employees. The bank will not want the theft publicised as the bank will not want to undermine public confidence in its servants. If the police are called in a prosecution must follow once a crime is detected. By using private investigators, the offender can be stopped and reparations can usually be exacted as a condition for not prosecuting: this makes much more economic sense for the bank. In fact, banks tend to have their own investigation departments but similar work is required by insurance companies and other firms. Interestingly, Mr. Withers decided to venture into franchising after he was engaged by a practising

franchisor to investigate the background of potential franchisees. He still does this type of work notably for Nissan.

Much work, if it would involve out-of-town travel for Mr. Withers or for a franchisee, is sub-contracted to other agents using the British Directory of Private Investigators. There are no significant examples of multiple franchises. Mr. Withers does run company-owned offices in areas not covered by franchisees. He also runs offices under different names (for example: Intercity Investigations, Associated Detectives and Premier Investigations) in areas which are franchised under the Nationwide trade name. In all, there are around 10 offices of one sort or another which are run by the franchisor. Along with the franchised Nationwide offices, these give some scope for the geographical transfer of work without resorting to separate sub-agents.

Nationwide belongs to the British Franchise Association. There is no franchisee association but annual franchisee seminars are held.

2. Nature of the franchise

No products are sold by the franchisor nor by any franchisee. The franchise relationship in this case arises over very specialised services which the franchisor supplies. First, he supplies a brand name which suggests national coverage by a chain of offices. This does result in business being generated for franchisees as most enquiries originate through the Yellow-Pages directory: customers tend to select Nationwide, or similar companies in preference to obviously local firms. This is due to the customer's fear of finding himself in the hands of less reputable operators. Secondly, the franchisee is trained in methods of operation, including mail-shot

advertising techniques, how to trace missing persons, and surveillance routines. Finally, enquiries for his area but received elsewhere in the network should be routed to the appropriate franchisee. The Nationwide franchise system is illustrated in Figure 1, where arrowheads show the directions of sales. Nothing in his contract prevents a franchisee from freely choosing whether or not to take a case.

I interviewed Mr. Withers at his London offices in Southwark. He believes that franchisees' obligations are to undertake all assignments which come to them, to portray the Nationwide image of an integrated network, and to operate discreetly and efficiently. In return, he hopes to offer comprehensive training and a full back-up to franchisees.

It is a full business-format franchise with manuals covering investigative, promotional and administrative procedures. No financial assistance is offered now since changes in credit law rendered the franchisor's credit company uneconomic to operate; there is also a liability problem if the franchisee fails. Franchisees are directed to sources of bank finance. Mr. Withers pays for training of the franchisee and his staff from the initial lump-sum fee which he charges. Advertising is at the franchisee's discretion except for a Yellow-Pages insertion which must be made using the company format.

It costs about £14,000 in total to start up as a Nationwide franchisee. This figure includes the initial lump-sum franchise fee, the cost of launch advertising, a maintenance insurance payment, a deposit placed with the franchisor equal to 13-weeks royalty payments, and the VAT which is due on all fees paid to the franchisor. The figure does not include any premium which a franchisee might pay to obtain a lease. Such payments would probably

not arise in the case of the offices likely to be rented by a franchisee. Unexpired portions of any lease would not be of great value as a typical rental might be around £700 paid quarterly. There would be no significant leasehold improvements to make. All of the outlay, except for about £4,000 consists of payments to the franchisor. It is all absolutely sunk expenditure without the need for any kind of reinforcement through contractual arrangements. The sum is not large compared with the initial outlay for some franchises, but may represent a considerable commitment to an investigator just starting up his own business. Essentially, the franchisee is investing in his own training and in obtaining the brand name, both of which are specific assets.

The only additional start-up expenditure would be on the provision of a suitable company car for the franchisee. This would have a considerable second-hand value and would most likely just be the franchisee's private car. It would not amount to an highly specific asset.

3. (i) The Agreement

Nationwide uses a fairly straightforward Franchise Agreement which runs to eight pages and principal clauses. A simplified outline of this now follows. A copy of the Agreement is available for inspection should this be required.

The franchise is granted for an initial term of five years with an automatic right of renewal for one further 10-year period providing the franchisee is not in breach of his contract. The initial franchise fee is set at £7,500 and an additional sum of £1,950 must be deposited with the franchisor. This deposit is forfeited if the franchise fails, giving the franchisor 13-weeks

guaranteed royalties. The royalty is not levied as a percentage of turnover but as a flat-rate weekly charge of £150. All these figures attract VAT which may be claimed back by the franchisee. The renewal of the Agreement incurs a charge which may not exceed the existing £7,500 fee. The royalty is linked to the Retail Price Index and subject to review every 30 months.

The franchisor undertakes not to open up an office under the Nationwide logo within the franchisee's territory, to provide training at the start-up, and to be available for consultation over any operational matter. The territory is written into a blank space in the Agreement, and consists of a Yellow-Pages area. Nationwide will rent and have title to all telephone lines, with the franchisee paying for all calls.

The franchisor retains the right to insist that any lease held in the franchisee's name should be assigned to Nationwide, providing the landlord agrees. This could enable the company to retain any goodwill attached to a site should a franchisee wish to close down and move on. The control of telephone lines performs a similar function. Later in the Agreement, the franchisee covenants not to compete with Nationwide within his old territory for one year after any termination, which helps the company to keep goodwill and client lists.

All employees of the franchisee must be approved by Nationwide before they may be hired.

The franchisee undertakes to pay all fees within seven days of the date on which they fall due. Apart from paying the initial fee, the deposit and the weekly royalty, he accepts liability for the cost of his local advertising, telephone calls he receives on the Freephone system operated by Nationwide, and for maintaining his

computer system. He also agrees to pay a fair proportion of the cost of any insurance taken out by Nationwide but also covering the franchisee against professional-negligence risks. Clearly, there is room for debate in interpreting this last clause of the Agreement. In addition, any accounting services provided by Nationwide must be paid for. The franchisee accepts the right of the franchisor to charge interest at 4% more than Barclay's Bank base rate on overdue fees of whatever kind.

The franchisee accepts a number of clauses which are designed to ensure he operates in a manner which is consistent with the rest of the network. He must keep proper accounts and comply with the operating procedures laid down in the manuals. He grants the franchisor the right to vet his advertisements and agrees to place at least one Yellow-Pages advertisement. A reliable motor vehicle must be run.

Importantly, the franchisee agrees to charge the standard rates published by Nationwide. Such an agreement would probably be unenforceable in the courts. Its function must be to prevent the franchisee from undercutting the prices charged by other Nationwide offices, including company-owned ones and by offices run under other names by Mr. Withers. No customer would complain if he found a franchisee charging less than centrally advertised rates: the discount would be gladly accepted and not taken as an indication that no national network existed. Furthermore, unless he is concerned about competition for his owned offices, the franchisor should only be interested in ensuring that the franchisee does not charge prices which are too high and which would prevent his business from growing: that would adversely affect the recruitment of new franchisees. An example of the 1987 standard charges is given in Appendix II.

The franchisee covenants not to have any kind of involvement in a competing business without the franchisor's written approval. No public statements are to be made through any medium, concerning the franchise, without Nationwide's permission; in particular, methods should not be divulged. The franchisee states that he will not commit acts of bankruptcy or criminal offences. He will neither solicit business outside of his own area nor entice employees of the franchisor or of any other franchisees to come and work for him. Finally, he indemnifies the franchisor against all liabilities arising from operation of the franchisee's business.

The Agreement may be terminated by the franchisor if payments are more than seven days late or for breach of any other clauses by the franchisee. In addition, this can follow if the directors of the franchisee's business change in a manner which is unacceptable to Nationwide. If termination occurs, the franchisee must cease trading, pay all outstanding debts and hand over his business telephone lines. No period of notice is specified for termination of the agreement.

The franchisee may sell his business with the franchisor's written consent; 10% of Resale price is to be paid to Nationwide. If the franchisee dies then his beneficiaries may take over the business. No details of the transfer to beneficiaries are provided.

There is only one purely technical clause which states that no agency is conferred by the Agreement.

Mr. Withers describes his Agreement as straightforward and having been altered over time in the light of experience. The need for some clauses became apparent whilst others emerged as redundant. There are no striking omissions although more details could be useful over

procedures for inheritance of the franchise. The Agreement has a number of unusual terms: the deposit held by Nationwide against fees owed by the franchisee: the weekly flat-rate royalty: and the exact fixing of prices.

3. (ii) Implicit aspects of the contract

The franchisor has comparatively recently written new conditions into the Agreement which incorporates business understandings into the explicit contract. This should be borne in mind when considering the few implicit aspects of the contract reported below.

The franchisor came to feel that territorial restrictions which he originally set, in which business originating outside of a franchisee's or company-operated territory would be transferred at a commission to the appropriate office, were largely ignored. The breaches were not acted on as Nationwide did not regard the matter as sufficiently serious to warrant jeopardising the long-term benefits of an association. The territorial arrangements have now changed: an office may take business from anywhere but must not seek customers outside of the territory.

Another understanding which existed for some time concerned under-reporting of turnover in franchised offices. Investigation is a business with a lot of cash payment where it is easy to hide revenue. Up until 1983, Nationwide charged a 10% turnover royalty and tolerated under-reporting, again not wishing to disrupt long-term benefits from the franchise network. This understanding disappeared in an odd sense: the franchisor moved over to the flat rate weekly commission having decided that no cost-effective means existed to police the old system.

An implicit aspect of contract which currently exists covers equipment loans between offices. It is accepted by all parties that loans are to be made when requested at hire rates which are set by the franchisor. The matter is not in the Agreement but is governed by the reciprocal benefits to franchises and Nationwide from operating such a system.

It is also currently understood that modest amounts of business may be directed by the franchisor to his other companies. Franchisees believe that this happens when enquiries come into the London office of the franchisor. This type of thing would be virtually impossible to prove and may anyway not be worth policing by franchisees. However, reputation effects hold the practice in check: a reputation for large amounts of redirection would adversely affect the franchisor's recruitment of franchisees,

3 (iii) Enforcement and monitoring

Mr. Withers claims that he seldom refers to the Agreement in his dealings with his franchisees. Nevertheless, franchisees are aware of occasional citation of the Agreement. Furthermore, in two cases, Mr. Withers sued franchisees to prevent them from continuing to trade under the Nationwide name after they had stopped their payments. The franchisor does not shy away from legal enforcement of his rights.

The franchise system is not dispute free. Conflicts have arisen in four main areas. First, some franchisees have come to feel that they could manage without the franchisor once he has trained them. They have thus attempted to trade without paying fees. Secondly, the franchisor has felt that under-reporting of sales has occurred in the past under the old sales-royalty system.

Thirdly, some franchises have had difficulty in paying fees to Nationwide. Finally, franchisees do not initially realise that the clause of the Agreement which prevents Nationwide competing with franchises still permit Mr. Withers to operate other companies. They often find these others competing with them.

Disputes have been resolved by a number of means. The royalty system has been changed so that under-reporting incentives no longer exist. Ex-franchisees have been taken to court over continuing use of the name and injunctions have been granted. Three franchisees with payment problems have had their Agreements terminated. Sometimes disputes are not resolved: franchisees simply tolerate the franchisor's competing companies, once they are discovered.

Given the design of the royalty system, there is no need for franchisees to report their returns to the franchisor. In addition, it is not the franchisor's practice to observe his franchisees whilst they are at work.

Mr. Withers states that a total of six franchisees have not renewed their Agreements. This is a very high proportion relative to the 10 who are left.

4. Why franchise?

Mr. Withers believes that franchisees are more entrepreneurially inclined than paid managers. In particular, they are more likely to seek business in times of recession. The quality of relationship likely to be built up between the franchisee and his clients is also thought to be better, compared with employing a manager.

However, the franchisor emphasises that franchising solves problems of under-reporting of business returns which he knows affect company offices. Given the unusual weekly fixed royalty, the franchisee has zero incentive to under-report. Mr. Withers believes that even a sales-royalty system would reduce incentives for misrepresentation. This is because the returns from dishonesty are reduced to the small percentage sales royalty in place of the whole fee which may be retained by a manager. Also, the franchisor can concentrate his monitoring on the franchisee alone. The long-term value of the franchise link also helps to reinforce honest reporting.

Mr. Withers also perceives capital-raising advantages for himself from franchising. He decided to franchise after observing systems in practice whilst undertaking work for another franchisor. He felt at the time that franchising could remove a capital constraint on expansion which he faced. This view, widely held among franchisors, runs counter to economic analysis, as noted in other cases, and is further analysed elsewhere in this work.

Mr. Withers believes that his franchise system gives two advantages to franchisees. First, he trains franchisees in highly specialised procedures; we can note that this is not a long-term basis for the franchise relationship. Secondly, he believes that the Nationwide brand name is of value as it is well recognised. Conversations with franchisees supported the importance of these benefits.

5. Fees and returns

A lump-sum initial franchise fee of £7,500 is charged. For this, a franchisee receives training at Nationwide's head office and a (second-hand) Sirius computer system.

It seems likely that some of this fee is a profit for Nationwide, given that training is on the job in the unpaid employment of the franchisor, and given that the computer systems appear to have a very low opportunity cost for the franchisor.

As described above, Mr. Withers also charges a deposit equal to 13-weeks royalty payment. This amount appears to act as a permanent interest-free loan to the franchisor. In part, it simply assures him a minimum return on the effort of setting up a new franchise. It also acts as a performance bond for the franchisee: if he fails or breaks the Agreement, the amount is given up. The device increases a franchisee's commitment to business success.

As described in Section 3(i) above, a weekly fixed-sum royalty payment is levied. This is index linked and subject to review every 30 months. The reasons for adopting this method of continuous royalty are discussed in Section 3(iii). Briefly, the weekly charge removes all requirements for monitoring a franchisee's returns. It is interesting to note that Mr. Withers has not simply increased his initial fee to achieve this end: the weekly system leaves the franchisor with an incentive to at least ensure that franchisees remain in business if this is at all possible.

The franchisor claims that franchisees should be able to earn a good living from a franchise and provides an annual business projection illustrating this to potential franchisees. The 1987 version of this is given as Appendix I2, which shows a combined profit and wage ('drawings') of around £15,500 for the franchisee. This would be a good annual return for a small businessman working in the U.K. Interviews with franchisees revealed that their performance varied considerably: one makes a

good living whilst others do not achieve the projected earnings.

The franchisor has a number of devices which may be used to extract any economic rents which may arise at the franchisee's end of the business. In principle, he could vary the initial fee and the weekly royalty when establishing an agreement. Once this has been done the scope for responding to changing market conditions becomes limited: the royalty is index linked and the renewal fee is specified in the existing Agreement.

The Franchisees

1. Franchisee I₁

I₁ was a XXXX prior to establishing his franchise in 1984, taking over an established company-owned office. He is typical of the kind of franchisee that Mr. Withers tries to recruit: he has a background in some kind of investigatory work, is young, and has a strong wish to be self-employed. He claims that the XXXX office has, under company ownership, suffered from absconding managers who had made off with equipment and money. The move to a franchise accords with Mr Withers's claim that franchising overcomes problems of monitoring honest reporting. I₁ undertakes the range of matrimonial, industrial crime, insurance and search work which the franchisor describes as normal for a branch. His full-time employees consist of one agent and one secretary. In addition, six part-time agents are employed. Although Nationwide prefers a strictly single-site operation, I₁ works alongside a separate debt collector and does not undertake this type of work himself. Both he and the debt collector are located within a solicitor's office suite; I₁ believes that the arrangement leads to complimentary services being available for clients at the same location. I observed

that this in fact diluted the business identity of the Nationwide operation: it is very difficult to locate I₁'s office by enquiring after Nationwide Investigations in XXXX.

The franchisee believes that his principal obligation is to follow the Agreement in his operations. In return, he expects the franchisor to provide full managerial support for his activities by, for example, being available for consultation over problems which may arise. I₁ received much training at the start of his franchise but now claims "Just to get on with it". He perceives the franchisor as "Someone who would be merciless if crossed" and is aware that contractual requirements have been enforced through the course in the past. Nevertheless, he feels that he could not have become established without the training and support. Although some franchisees feel that they receive little in return for their fees, I₁ is personally satisfied and intends to remain within the network.

The main benefits of belonging to the Nationwide organisation are the training and the brand name, according to I₁. The name does reassure clients in his experience, as claimed by Mr. Withers. I₁ believes that his business is better as a result and sees his fees as buying this improvement. His franchise fees are a little lower than those currently charged by Nationwide: he pays £100 a week and paid a £5,000 lump sum. He believes that the lump sum was fully spent on starting his business.

Interestingly, the franchisee believes that there are territorial limits on sales and not just on seeking business. This is because he has an older (pre-1986) version of the Agreement. The older contract also explains the difference in fees.

2. Franchisee I:

I₁ began as a franchisee in 1980 having previously worked for Nationwide as a senior investigator in London. He has two branches: one in XXXX employing two agents and a secretary and another in XXXX with one agent and a secretary. A small number of part-time agents are casually employed. The business consists of enquiry work and debt collecting.

I₁'s two offices are leased on annual contracts and are not high-street premises. He believes that he has little capital tied up in the business. Most of the expenditures which act to commit him to Nationwide consist of payments to the franchisor. He confirms the structural details of the franchise system which are reported by Mr. Withers. I₁ has renewed his Agreement, which now contain the current details. He pays a total of £300 each week as a royalty and paid the current franchise fee to renew each agreement in 1985.

The franchisee describes the main benefit of belonging to the Nationwide network as the ability to use the brand name. However, he also states that there is a strong negative incentive to remain within the organisation as a professional limitation clause in the Agreement would prevent him from trading in his areas for a period of one year were he to leave. Furthermore, the contractual requirement that client lists should be returned to Mr. Withers in the event of termination reinforces the difficulty of independent trading. I₁ states that the franchise system is fraught with conflict. In particular, financial projections are not borne out and franchisor support is low. He describes his experience as that of becoming locked into a relationship which is of little positive benefit but where he has accepted contractual provisions restricting his ability to work alone. He is

literally buying the right to be in the business with a client list that he has built up. "They have me well stitched up", as he puts it.

I₂ confirms that the franchisor does quote the terms of the Agreement occasionally. He has been in dispute with Mr. Withers over payments. As I₂'s business was not profitable for some years (it now breaks even) he has fallen behind on his payments from time to time. Nationwide charged interest on the lapsed payments as permitted by the Agreement. At one point I₂ was met at his office by company agents who had been sent up to take over his business and run it as a company branch. He states that he literally threw them out and regards such an attempt to take over the client list that he had built up as opportunistic. In the event, he managed to find sufficient funds to meet his immediate debts with the franchisor and eventually broke free of his indebtedness altogether.

It is noteworthy that I₂ believes that it was better to remain in the network as a means of clearing his debts to the franchisor. At the time he signed his second set of Agreements he could have simply declared himself bankrupt. He felt that continuing to buy access to his client lists gave him the best opportunity to clear his debts. It is also notable that the franchisor could have closed him down by treating the payments problem as a breach of contract. Mr. Withers must also feel that the franchise arrangement is of net benefit despite the difficulties.

3. Franchisee I₃

I₃ took on his franchise in 1981 when the franchisor sold off what appeared to be his principal business area. Previously I₃ had been XXXX for the franchisor and had then spent time helping and monitoring new franchisees in

the early days of Mr. Withers' operations. When the franchise system was revised so that a fixed weekly sum replaced a sales royalty, I₃'s monitoring role became redundant. Mr. Withers offered him the XXXX franchise after he turned down an expensive share offer in Mr. Withers' company. Until 1986, I₃ was in partnership with another ex-Nationwide employee. He has four full-time employees and uses a number of part-time agents.

At first glance, I₃ appears to have a very substantial business concession from Mr. Withers. I₃ states that his annual business turnover is around £200,000 which is well above the performance targeted for or achieved by other branches. However, he does compete with the franchisor in XXXX. It was from I₃ that I learned of the franchisor's separate companies. After I₃ had signed an agreement, Mr. Withers set up Associated Detectives in XXXX. The Agreement states only that Mr. Withers will not compete as Nationwide with his franchisees. Not surprisingly, this train of developments is regarded by I₃ as a case of post-contract opportunism on the part of the franchisor.

Nevertheless, I₃ renewed his Agreement for a further 10 years in 1986. His reasons are similar to those put forward by I₂. Only by staying with the network could he continue to operate within XXXX using the client list which he has built up. In I₃'s case, this is not seen as the efficient way to deal with debts: rather his income from the business is good. However his Agreement rules out operation in the area to all practical purposes if he were to leave Nationwide. In negotiating a new Agreement, I₃ concentrated on enhancing his own security of tenure in his business: settling for a new 10-year term with an automatic right to renew for a further 10 years and with a limit of £20,000 on the fee for the future contract. He paid double the standard fee for this contractual variation. He is resigned to the franchisor's competition

in XXXX and to his suspicion that enquiries received by Mr. Wither's Nationwide headquarters in XXXX, but which should be redirected to I, if they are for the Nationwide XXXX service, are in fact absorbed by one of the franchisor's companies. The business remains sufficiently valuable for him to wish to remain in the network.

I, confirms the structural details of the franchise system reported by Mr. Withers. He also reports his understanding that the franchisor is orientated towards citation of clauses of the Agreement from time to time. He knows that franchisees have been taken to court. He also feels that since letting XXXX become franchised, Mr. Withers has had second thoughts and would like to regain control of XXXX operations under the Nationwide name. I, believes that any excuse would be used to claim a contractual breach as the basis for walking away with his fees and his client list. This prospect is reinforced by the franchisor's right to remove files from his office, as detailed in the Agreement.

Mr. Withers holds the lease on I,'s office. This is not a problem as I, could relocate if he wished. There is no restriction in the Agreement to prevent this. Title to the telephone lines attached to the business, which resides with the franchisor, is another matter. Together with a limitation on post-termination competition in his area this reinforces the franchisee's wish to remain within the network. I,, like I,, believes that he receives little for his fees apart from the right to continued access to a client base that he has built up.

I, received no training at the start of his franchise. This was principally due to his existing level of knowledge. He describes continuing support from the franchisor as minimal.

My observations were of a busy XXXX office operating on a much larger scale compared with other branches.

Summary

Nationwide Investigations gives rise to an interesting case study of franchising. Over time the franchisor has minimised his monitoring of the operations and performance of franchisees: monitoring staff have become redundant as a weekly flat-rate royalty system has been adopted. Despite misgivings by franchisees that, once trained, there is little positive advantage to being part of the franchise network, they often negotiate new Agreements when these are due for renewal. This is so as not to lose access to a valuable client base.

Attempts by some ex-franchisees to continue to operate under the Nationwide trade name have been stopped in the courts by Mr. Withers. It is important to him that these moves should be policed. Given that he offers little continuing support to franchisees after any initial training, the franchise relationship can only continue if access to an established client base is strictly by membership of the Nationwide network.

The lump-sum initial franchise fee and the weekly flat-rate royalty can be used by the franchisor to extract any economic rent which might occur at the franchisee's end of the business. The experience of the three franchisees interviewed in this case suggest that a haphazard transfer of profit occurs: I₁ is left with a very good income after paying his fees; I₂ makes a modest income; and I₃ has made a substantial loss. There is no systematic extraction of all economic rent, viewed from the franchisee's perspective. This is curious since the contractual clause limiting competition from an ex-franchisee enables the franchisor to do this in principle. He may be concerned

over the need to attract future franchisees (although this does not fit in with his practice of competing with franchisees through other companies which he owns) or he may be unable to calculate a suitable schedule of fees. The rent transfer which occurs may be regarded as a fee for using a brand name or initial training facility, both of which the franchisor owns.

It is interesting to note that whilst there is no contractual reinforcement needed to turn initial investment sums into sunk costs, things are different with the franchisee's investment of effort in building up his client base. This goodwill asset can be rendered worthless by the franchisor through the clauses limiting post-termination competition from a franchisee who chooses not to renew his Agreement. The franchisor's control of telephone lines and his right to remove files should also be viewed in this light.

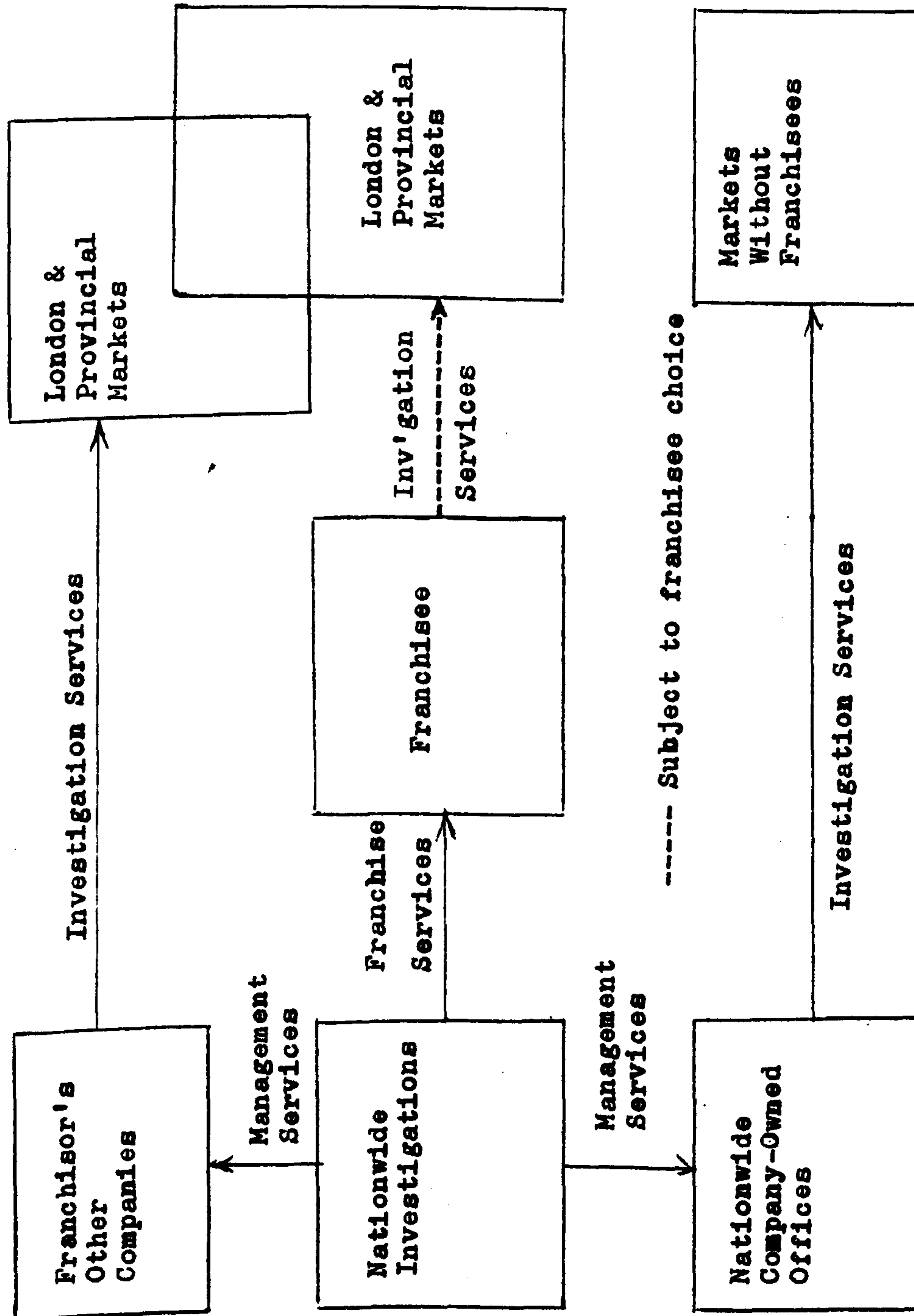


Figure I Nationwide Franchise System

NATIONWIDE INVESTIGATIONS GROUP

| RECOMMENDED SCHEDULE OF FEES AS FROM 1st JANUARY 1987 IN POUNDS STERLING | Class 1 | Class 2 | Class 3 |
|---|---------|---------|---------|
| MON-FRI BETWEEN 0900 & 1800 hrs | 20.00 | 22.50 | 25.00 |
| WEEKENDS OR PUBLIC HOLIDAYS OR BETWEEN 1800 hrs & 0900 hrs | 22.50 | 25.00 | 27.50 |
| PER DAY - 10 HOURS | 200.00 | 225.00 | 250.00 |
| PER WEEK - 5 DAYS | 1000.00 | 1125.00 | 1250.00 |
| VEHICLES | 1600cc | 2000cc | 3000cc |
| HIRE OF CAR PER DAY | 25.00 | 35.00 | 50.00 |
| HIRE OF CAR PART DAY (minimum) | 12.50 | 17.50 | 25.00 |
| MILEAGE WHERE APPLICABLE | 40p | 50p | 60p |
| HIRE VEHICLES WHERE NECESSARY - HERTZ RATES PLUS 10% HANDLING | | | |
| TELEPHONE COSTS - AS CALCULATED PLUS 20% | | | |

BUSINESS PROJECTION

International Private Investigators

| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC | TOTALS |
|----------------|------|------|------|------|------|------|------|------|------|------|------|------|--------|
| RENT/INS | 675 | - | - | 675 | - | - | 675 | - | - | 675 | - | - | 2700 |
| SECRETARY | 200 | 200 | 200 | 200 | 200 | 200 | 400 | 400 | 400 | 400 | 400 | 400 | 3600 |
| PRINT/STAT | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 300 |
| LOAN REPAYT | 215 | 215 | 215 | 215 | 215 | 15 | 215 | 215 | 215 | 215 | 215 | 215 | 2580 |
| POST | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 1200 |
| MOTOR EXPENSES | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 1800 |
| DRAWINGS | 600 | 600 | 600 | 800 | 600 | 00 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 10200 |
| ROYALTY | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 650 | 7800 |
| TELEPHONE | | | 300 | | | 300 | | | 300 | | | 300 | 1200 |
| SUB AGENTS | | | 100 | 150 | 200 | 200 | 250 | 250 | 250 | 300 | 300 | 250 | 2250 |
| LEGAL & PROF | | | | | | | | | | | | 1000 | 1000 |
| <hr/> | | | | | | | | | | | | | |
| | 2615 | 1940 | 2340 | 2965 | 2340 | 2640 | 3465 | 2790 | 3090 | 3515 | 2840 | 4090 | 34630 |
| SALES | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 3330 | 39960 |
| <hr/> | | | | | | | | | | | | | |
| NET PROFIT | 715 | 1390 | 990 | 365 | 990 | 690 | -135 | 540 | 240 | -185 | 490 | -760 | 5330 |

NATIONWIDE INVESTIGATIONS

-Appendix I2 Nationwide Projection

CASE J BUDGET RENT A CAR (UK) LIMITED

The franchisor

1. Background

Budget was founded in 1958 in the USA as a one-location 12-car operation. It has since grown into a major international car-rental business with 3,100 outlets spanning 101 countries. Virtually all outlets are franchised, following a policy adopted in 1960 when serious expansion began. Budget Rent A Car (UK) Limited operates as a wholly owned subsidiary of Budget Rent A Car International which is incorporated in the USA. The UK company has responsibility for Europe, Africa and the Middle East, issuing master franchises outside of the UK as well as recruiting individual franchisees in the home market.

There are 115 outlets which are owned by 65 franchisees in 1987. On average each of these stations employs around 30 people. The franchisor also has approximately 100 direct employees, mostly engaged in running the central administration at Hatfield. Budget is a major car-rental firm comparable to Avis in the UK but with rather more reliance upon franchisees. Current market share stands at about 10% of national car rentals (the total UK market is worth about £275 million in 1987). The business arises in roughly equal proportions from corporate and private users. About 15% of revenue accrues on van rentals. Like other national car-rental operations, Budget does not hire out heavy commercial vehicles.

The franchisor prefers to recruit franchisees who intend to operate single-use sites. In practice many stations are established on motor-trade sites. Budget

rule out fractional franchises but strives to avoid dilution of its broad image and to be independent of the fortunes of the general motor trade. The policy follows experience of the recession in the UK motor trade in the early 1980's when Budget lost 50% of conjunctive-use sites. 60% of stations still fall into this category.

Some franchisees have multiple franchises. A number have become quite large chains as in the case of J₂ which has the xxxx-Airport franchise among others.

The franchisor is an established member of the British Franchise Association. Franchisees have an association and participate in annual conferences.

2. Nature of the franchise

Budget offers a full business-format franchise with manuals covering operating, sales and administrative procedures. A computerised central-reservations system (Braccnet) operates and is linked by satellite to overseas reservations. Budget does not normally assist franchisees with finance but has occasionally given help for special reasons. A national sales team is employed to develop corporate accounts.

A franchisee has the exclusive right to use the Budget trade name within a sales territory, to participate in an one-way rental system, and to benefit from centrally recorded reservations. Company supply lines may be used to purchase or lease vehicles from major manufacturers (principally Ford and Vauxhall). As with Avis (Case C) the terms are favourable as manufacturers regard car-rental fleets as good advertisements. Figure J illustrates the Budget franchise systems, with arrowheads showing the direction of sales. Strictly speaking, the franchisee is not free to choose whether to service any

particular customer as he is contractually bound to accept central bookings. Vehicles arriving on the one-way rental system from other franchisees are serviced and returned at the originating franchisee's expense.

I interviewed Mr. Keith Harman, Director of Franchise Development at Budget's headquarters in Hatfield. He believes that the franchisee's principal obligation is to maintain the standards of service specified in the franchise manual. In return, he sees Budget's responsibilities as providing maximum management support including the policing of operating standards throughout the network.

There are no stocks of products which would be specific to the Budget operations of a franchisee. Uniforms and display items are provided by Budget. Vehicles are either hired or would anyway have a reasonable second-hand value. Premises are leased or bought by the franchisee and can be easily adapted to other uses. Start-up costs for a franchisee are not quoted by Budget but, from franchisees' comments, it would seem reasonable to suppose that they are similar to those for Avis (Case C) and stand at around £30,000 (excluding franchise fees) for a basic station starting up with around 25 cars and 10 vans. Bearing in mind fleet lease costs, at most around 50% of this sum would represent sunk expenditure with the remainder being retrievable expenditure on non-specialised buildings and equipment. This amount, whilst significant, does not represent a large sunk investment.

3. Contract

3 (i) The Agreement

Budget uses a standard franchise agreement which is called the Licence Agreement following the practice in the car-rental industry. There now follows a simplified outline of the principal clauses of the Agreement. The terminology of franchisor/franchisee will continue to be used. A copy of the Agreement is available should this be required.

The Agreement is extensive and has 22 pages covering 70 principal clauses. 51 of the clauses refer to undertakings by the franchisee. The Agreement grants the franchisee the right to operate a vehicle-rental business under the Budget trade name within a specified territory. This grant is for an initial period of 5 years. The franchisee is required to abide by the provisions of the Agreement and of an operating manual in operating his business.

Budget undertakes to supply an operating manual covering sales, administration and fleet management procedures. Initial and continuing training is to be provided at the franchisor's discretion. Budget further undertakes to provide a business analysis of performance reports which are to be submitted monthly and annually (as certified accounts) by the franchisee. Central reservations are to be transmitted to the appropriately located franchisee. Budget agrees to spend at least 25% of annual franchise fees on marketing.

The franchisor takes the right to negotiate national sales contracts with businesses, government agencies and travel agents. The franchisee will service such contracts although the Agreement is carefully written to avoid any

explicit retail price fixing. Pricing advice is contained in the franchising manual.

The franchisee agrees to participate in both the systems of central reservations and of one-way rentals. In participating in nationally negotiated contracts with travel agents and others, he may charge his own rates although these must be heavily constrained by the recommended charges published by Budget. Similarly, the franchisee must honour standard vehicle reservations made by Budget on his behalf but without prior confirmation.

There are a number of minimum requirements which a franchisee agrees to meet. A minimum initial fleet and associated five-year growth plan is specified in the Agreement. Also listed is the name of an approved manager whom the franchisee must employ and who must follow Budget's initial training course (along with the franchisee). At least two telephone lines must be rented which the franchisee agrees to put in Budget's name. A facility for collision-damage waiver is to be offered to customers at a fee which the franchisee may determine. Standard rental agreements and accounting systems are to be used.

The franchisee agrees to pay an initial lump-sum franchise fee. The amount of this is not specified in the text of the Agreement but is entered into a blank space. The franchisor must also be reimbursed for separate expenses incurred at the start-up, including the cost of signs and uniforms but not advertising (the franchisor agrees to spend at least 50% of the first annual franchise fee on advertising). The annual sales royalty is set at 10% of the gross rental for cars and 5% for vans. Gross revenue is defined as revenue minus fuel, collision costs and taxes. 15-days grace is allowed on payments whereupon interest charges may be levied at 5% above the base rate

of the Midland Bank. The franchisee agrees to honour credit cards approved or operated by Budget. He also undertakes to spend 2% of gross revenue on local advertising and to give prominence to Budget's promotional material when this is supplied (free of charge). Budget is to be indemnified by the franchisee against any liability arising on the franchised business.

The Agreement is normally renewable, at the end of its five-year term, on an annual basis. Both parties may give notice of termination of the Agreement. The franchisee may give six-months notice during which time he must continue to perform his undertakings or be liable to pay damages to Budget. The franchisee may give 22-days notice if the franchisee fails to pay his franchise fees and 37-days notice for other failures. However, if the franchisee becomes bankrupt Budget may terminate without notice. Where notice periods are given by Budget, the franchisee may rectify his failures and avoid the termination. Also during a notice period given by the franchisor, the franchisee is liable for damages if he fails to perform his duties.

The consequences of termination are that the franchisee should pay all outstanding fees, stop trading under the Budget logo, return all trademarked items and hand over the use of the telephone lines referred to in the Agreement. In addition, the franchisee undertakes not to compete in a similar business within his old territory for a period of six months following the end of his Agreement.

Budget may freely sell or assign the franchise. The franchisee may sell or assign it subject to the franchisor's approval of a purchaser. Also, the franchisor has the option of first refusal on the franchise at a price offered by a third party. Any dispute over the value of assets is to be settled by

compulsory arbitration using a Chartered Accountant. The franchise may be inherited by a franchisee's beneficiaries. No management assistance with a transition is detailed in the Agreement. Inheritance is treated analogously to sale except that the first-refusal clause could not apply as it is currently written.

Finally there are a number of technical clauses. The Agreement is said to represent the entire contract (which in practice is not likely to be true in any business situation). The franchisee is not given agency powers in the legal sense and cannot therefore commit the franchisor by his actions. If the franchisor waives a clause there is no implication that the clause is forfeited thereafter. Clauses are severable. The Agreement is to be governed by English Law.

A personal guarantee form is attached to the Agreement. The purpose of this is to maintain the franchisee's liability for any debts owed to the franchisor even if his company is formed with limited liability. This device should increase the franchisee's commitment to his business.

Although a lengthy document, this Agreement is relatively straightforward and does not try to cover all eventualities. Much of the Agreement is used to clarify the definition of terms.

3(ii) Implicit aspects of the contract

Mr. Harman believes that unwritten understandings lead to problems in running a business and strives to avoid them. Nevertheless, he points out that some understandings have emerged. I interpret these to be implicit aspects of the contract as they are nowhere written down yet they form part of the relationship

between franchisee and franchisor. They are governed by the long-run value of the franchise relationship to both parties.

First, it seems to be understood that the franchisor will not enforce the clauses in the Agreement which impose penalties for late payment of franchise fees. Budget has not imposed interest charges and has been slow to persuade franchisees to become up to date over payments. It would seem that extreme caution has been exercised not to disrupt the long run franchise relationship over possibly short-term payment problems. Franchisees confirm that this attitude is now expected of the company.

Secondly, it is understood that franchisees will pay their own travel and subsistence costs incurred whilst attending training courses provided by the franchisor. Franchisees will make every effort to follow such training although they incur these costs, rather than risk jeopardising the franchise relationship.

Finally, payments for cars hired on the one-way system are not detailed in the Agreement but are revised from time to time by Budget less formally. Currently, the two hire fees involved are shared equally between the originating and receiving franchisee if the vehicle can be returned to base through hiring it out. Otherwise the originator receives all of the fee but must incur recovery costs. One-way fees are higher than regular tariffs. If a vehicle is used by a receiving-franchisee prior to its return as a one-way hire, then 80% of the hire fee must be paid to its owner.

The contract is relatively free of implicit aspects, reflecting the franchisor's attitudes in this area.

3(iii) Enforcement and monitoring

Mr. Harman states that Budget would only quote contract clauses in the last resort: in one case, a franchisee did not pay fees for nearly two years before any action was taken using the Agreement. In general, the franchisor strives to build a close management relationship with franchisees emphasising partnership aspects of this.

Franchisees report their performance details each month as required in the Agreement. Occasionally additional observations are made of the franchisee's business by the franchisor. Sometimes mystery-buyer techniques have been used for this purpose. Accurate reporting of sales is encouraged by the possibility of centrally received complaints revealing any bootlegged sale. Further reinforcement to honesty is given by the nature of the franchise arrangement: the franchisee only saves a modest royalty by hiding a sale and risks seriously disrupting his relationship with the franchisor.

An interesting feature of the Budget franchise system is that franchisees have the right to make a 20-minute unannounced spot check of any other franchisee. Franchisees voted to adopt this system through their association. It reflects the importance that franchisees as well as the franchisor attach to controlling poor outlets, which would have negative external effects on the reputation of all outlets. The franchisee's right to inspect his fellow franchisees adds an additional low-cost layer of monitoring which is likely to make use of the close knowledge of practising franchisees.

Mr. Harman describes the costs of monitoring and enforcement as "acceptably low", given the size of the network.

There have been few real disputes with franchisees, according to Mr. Harman. Some franchisees have felt that they have not benefited from the activities of national sales teams. Only one franchisee has voluntarily left the network (and moved to Avis). There have been some inefficient franchisees who have been encouraged to sell their franchises. Mr. Harman offers no figures for the number of encouraged exits but emphasises that this method of ending the franchise relationship is always preferable to litigious routes. In general, the franchisee aims to use exhortation and to rely on the advantages of good performance to the franchisee to encourage acceptable conduct of the business.

4 Why franchise?

Mr. Harman thinks that Budget offers franchisees a major brand-name advantage. Lesser but still important advantages are the discounts available on vehicles and insurance if franchisees use company supply lines. Central reservations and a sales team operated by Budget to boost business rentals generate revenue for franchisees. Mr. Harman emphasises the brand-name advantage.

Capital-raising advantages for the franchisor are not perceived by Mr. Harman. These were felt to be part of the benefit of franchising in Budget's early days. However, the company is now so large that it would have no difficulties in raising finance, according to Mr. Harman. The main advantage to the franchisor from franchising arises from the recruitment of financially committed franchisees: these are able to concentrate on building good local business relationships. Mr. Harman believes that Budget benefits from such local entrepreneurship.

5 Fees and returns

A 10% sales royalty is levied on the gross revenue of franchisees in the case of car rentals (5% for vans) as detailed in the Agreement. A lump-sum initial franchise fee of about £20,000 is charged. The initial fee varies from area to area reflecting the cost differences which Budget may face over such things as advertising at the start of business. Mr. Harman states that there is no real profit element in the initial fee: "Sometimes we make a small profit and sometimes we make a loss." VAT is added to all fees charged by Budget and may then be reclaimed from the authorities by franchisees.

Sales targets are set for franchisees and depend largely on the history of the area within which they are located. No sales projections were provided by the franchisor. This is because Budget prefers to make projections for specific sites when they are proposed. Mr. Harman believes that franchisee returns are good: currently the average return on sales stands at 12%.

The franchisees

1. Franchisee J₁

J₁ is the principal Budget franchisee for xxxx and operates a total of five franchises. His business is large, employing around 30 people. All of the sites except for xxxx are single use. The xxxx office is located on one of the xxxx car dealerships which J₁ also runs. He began as a franchisee in 1966 after seeing a circular which was sent to all xxxx dealers.

The nature of J₁'s business varies from site to site. xxxx rentals, including airport work, require a peak fleet in the summer of 75 cars and 10 vans. Two-thirds of this

work is for business accounts. xxxx has a similar peak fleet but almost all of the rentals are to private individuals holidaying at the resort. In total, including xxxx and xxxx, a fleet of around 270 cars and 40 vans operates. Budget central reservations generates approximately 30% of all rentals, according to J₁. Two-thirds of the total fleet comprises Ford vehicles which are leased through Budget supply lines.

J₁ sees his obligations as "Giving the right service" in relation to the Budget brand name under which he operates. He expects the franchisor to operate an efficient central-reservations system, to promote sales nationally and to establish good supply lines for vehicles and insurance.

The main advantage of being a Budget franchisee is the ability to trade under the established brand name, according to J₁. The next most important benefit is seen as the central-reservations system, which is important to him as his rentals arise in airport and major-city locations. Still important are the discounts on vehicles and insurance negotiated by Budget, the notional sales team, and the one-way system of vehicle hire. However, the franchisee does not emphasise these last three benefits and they seem less valuable to him than may be thought by the franchisor. J₁ finds Budget operating manuals to be useful in his business.

J₁ confirms that Budget is not heavy handed in enforcing franchise contracts. He cites instances where the clause of the Agreement which requires that an ex-franchisee should not compete in the same line of business for six months after leaving the network is not enforced. Also, he feels currently motivated to complain about the performance of a neighbouring franchisee who, he judges, is not being brought up to standard by Budget.

J₁ describes the central-reservations system as having been badly organised a few years ago. The franchisor was responsive to exhortation from franchisees and has now improved this. The system's shortcomings, with reservations often simply becoming lost, was a major source of conflict within the Budget network. J₁ believes that the major incentive for both franchisee and franchisor to settle any differences stems from the long-term value of their business relationship: "They receive a lot of money from me and I enjoy business generated on their name and systems."

J₁ confirms the structural details of the franchise system which are described by Mr. Harman. Based on his knowledge of equipment and advertising costs, J₁ believes that the franchisor makes a modest profit at best from the initial fee. The franchisee considers his own returns to be good and intends to remain in the network.

I interviewed J₁ at his xxxx offices. My observations were of a busy local vehicle-rental outlet with some personnel shared with the car dealership occupying most of the site. The Budget identity is not lost.

2. xxxx, General Manager, J₂

J₂ was established in 1960 as an xxxx-xxxx company. It bought the Budget franchise for xxxx in 1977 and has since then added franchises at xxxx, xxxx, xxxx, and xxxx. This franchised operation is very large with a total fleet of about 800 cars and 50 vans. There are 130 employees of whom 90 are based at xxxx, which is by far the largest part of the operation. J₂ is currently owned by xxxx, the Budget master franchisee for xxxx. I interviewed xxxx at the xxxx unit.

XXXX sees the franchisee's obligations as preserving Budget's corporate image and conducting the business in an honest manner. In return, he expects Budget to give marketing support, to obtain good supply lines, to provide a central-reservations system, and to monitor franchisee performance throughout the network.

The main benefit of belonging to the Budget system comes from trading under the brand name, according to XXXX. Less important benefits are the central-reservations system and the discounts obtained by Budget on vehicles and insurance. XXXX believes that the importance of vehicle discounts has grown recently. In 1986, J₂ moved from negotiating directly with vehicle makers concerning leases to relying on Budget supply lines. This has saved them a great deal of negotiating costs in terms of management time. Nevertheless, it is the advantage of the brand name which is emphasised.

xxxx uses the franchisor's manuals in operating his business. These are found to be useful but are augmented by his own experience. In accordance with Budget's wishes, all sites operated by J₂ are single use.

The franchisee's experience confirms that Budget is easy going in enforcing aspects of the Agreement. xxxx and xxxx are very expensive-to-operate but lucrative airport markets which suffer from "poaching" of customers by neighbouring franchisees. xxxx complains that the franchisor does little to stop this beyond exhortation, and believes that Budget's managers are too concerned not to seem heavy handed over enforcement of details like operating territories. He also claims that sales revenue was not monitored for some months prior to our interview.

xxxx confirms the structural details of the franchise system which are described by Mr. Harman. Along with J₁,

and based on his trade knowledge, he believes that no more than a modest profit is made by Budget on the initial fee. J.'s profitability is good and there is no intention to move away from the current set of operations.

My observations were of a major car-rental operation which is fast taking on the characteristics of a large company. Nevertheless, the Budget image is not compromised.

3. Franchisee J,

J, became a Budget franchisee in 1983. He has two sites: one at xxxx and the other in xxxx city centre. The city-centre site is shared with J,'s other business venture, a commercial vehicle dealership. He employs 10 people in his Budget operations and runs a peak fleet of 45 cars and 45 vans over the two sites. Only 20% of his business is generated through central reservations. He believes this, together with his greater use of vans compared with other franchisees, is explained by his location.

The franchisee sees his obligation as operating within the standards set by Budget nationally. In return, he expects the franchisor to promote the brand name at home and abroad, to provide a central-reservations system, and to establish supply lines for vehicles and insurance.

The main benefit of being a franchisee is still seen as the ability to trade under the brand name even though J, benefits less from centrally generated bookings in xxxx. He emphasises that "Much local business is because of the Budget name". Only 25% of his vehicles are leased through Budget supply lines, with the rest being purchased directly from manufacturers. The supply lines are not considered to be a major benefit by J,. Budget's

operating manuals are found to be useful, especially for calculating the prices to be charged on any centrally generated rentals.

J, confirms the easy-going nature of the franchisor when it comes to enforcement of the Agreement. He has never had his Agreement referred to in any way. It is definitely filed away although 'It is not forgotten.' J, makes monthly sales-revenue returns and sees an area manager every two months. He is aware that there were worries over the efficiency of the central reservation system and that franchisees succeeded in obtaining a better service from Budget.

J, also confirms the structural details of the Budget franchise system given by Mr. Harman. Along with the other franchisees, he feels that the initial franchise fee could not have contained much of a profit element for Budget. J, is happy with his own financial performance and intends to remain with the Budget network.

My observations were of busy sites which have the appearance of small-business outlets. The Budget corporate image is maintained because of the prominence given to the standardised signs.

Summary

Budget Rent A Car is an entirely franchise-based operation in the U.K. In the early 1980's, the company experienced problems with the loss of some franchised outlets which were dependent on the depressed fortunes of the general motor trade. There has been recovery from this position although the company still accepts conjunctive-use sites.

Franchisees principally benefit from the ability to trade under the Budget trade name and in return provide local entrepreneurship for Budget. Supplies discounts are not as valuable to franchisees as Budget managers may believe. Franchisees have some concern over the policing of standards throughout the network and have taken the right to mount their own spot checks of one another.

The franchisor can extract economic rent from the retail end of the business through the setting of the initial fee and the royalty payment. However, once these are set no possibility exists for varying the division of profits as market conditions change.

It is interesting to note that the fees which accrue to franchisees for returning vehicles arriving at their premises on the one-way rentals system, or which arise if their vehicles are used by other franchisees, seem to lead to reasonably harmonious operation of the system. In comparison with Avis (Case C) these fees are higher. Avis does experience franchisee dissatisfaction over the operation of its one-way system, which I would suggest arises because of the extension of operating practices developed during its days as a company-station-only system. Budget has always been a franchised system and has a system which better suits franchisees. In time, I would expect changes in the Avis vehicle transfer charges.

----- Subject to franchisee choice

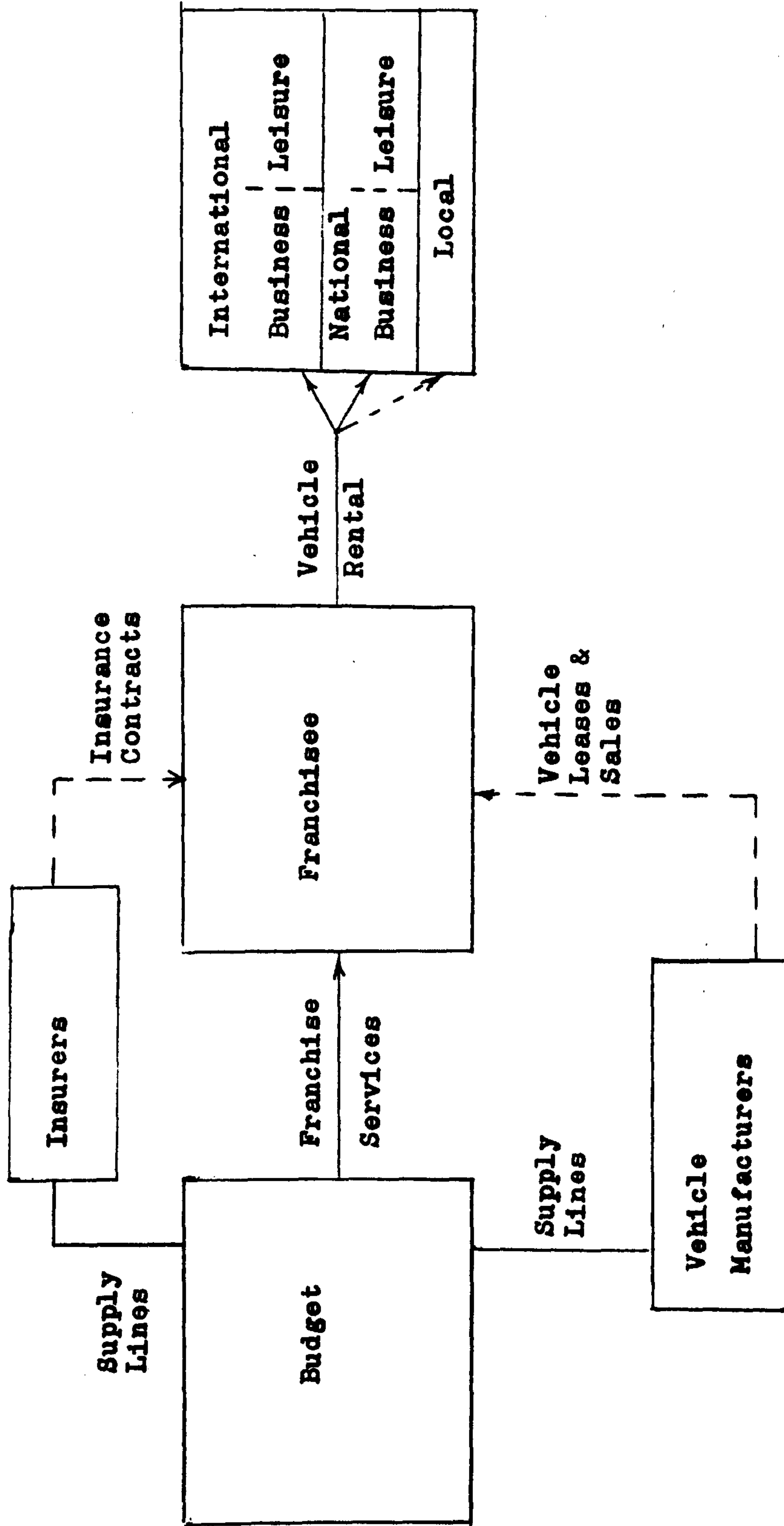


Figure J Budget Franchise System

CASE K MIDAS

The franchisor

Midas (Great Britain) Limited was established in 1967 by its US parent company. In the USA, the company has franchised its network since 1954. Worldwide there are now around 2,000 outlets. Midas's advertising material claims that the company is the world's largest retailer of vehicle exhaust, brake, and similar fast-fit services.

Franchising did not begin in earnest until 1981 in the UK. An early attempt in the 1970s was not a success.

There are currently (1987) 12 franchisees with 15 outlets plus another 37 company-owned service sites. Each employs around five people so that the UK network of 52 outlets has approximately 260 employees. There are the franchisor's head office staff of around 20 to add to this estimate of size. Most branches are based in London, the South East and the Midlands.

Principal markets which are served are those for exhaust and brake servicing on cars and vans. Some outlets sell tyres, and undertake suspension work. Of these markets, growth is being experienced in brake, tyre and suspension services. Exhaust work is in decline.

Midas is a member of the British Franchise Association. There is a franchisee association which meets regularly.

There are no fractional franchises at the present time, although the franchisor has no strong objection to these. Franchisees ^{may} have more than ^{one} franchise.

2. Nature of the franchise

In return for paying his fees, a franchisee receives the use of the Midas trademark on his premises, uniforms and equipment, and the full marketing support of the franchisor. In the UK, Midas supply lines have been established so that franchisees can obtain discounts on parts. The franchisee's source of parts is subject to the franchisor's approval. This contrasts with USA practice, where the franchisor makes the parts. The franchise is of the full business-format kind, with manuals covering all operating procedures.

The Midas franchise system is illustrated in Figure K, in which arrowheads show the direction of sales. There is nothing in the franchisee's contract which limits his freedom to choose whether to service any particular vehicle. 'I interviewed Mr. Ken Phillips, Midas's Marketing Manager, at the company's head offices in London. He sees a franchisee's principal obligation as maintaining standards and practices in accordance with guides given in the franchise manuals. In return for this, Midas gives full managerial systems support, including a national advertising effort and training.

A franchisee would need around £100,000 to set up his business. Most of this would be spent on the design and fitting out of his premises. Perhaps 40% would be spent on equipment which has a fair second-hand value. The premises must be leased through Midas who then have the ability to prevent the franchisee from adapting them to other uses. At least one-half of the initial investment, plus the lump-sum initial fee which the franchisor charges, can be regarded as sunk expenditure on the part of the franchisee.

Midas gives no financial help to franchisees. At the start of their business enquiries, franchisees are directed to standard franchisee packages which are offered by the major banks.

Mr. Phillips states that Midas is aiming to sell virtually all of the company-owned outlets to franchisees in the near future. Any which remain will be based in London.

3. Contract

3(i) The Agreement

Midas uses a comprehensive Franchise Agreement which runs to over 40 pages and contains 28 main clauses. There now follows a simplified outline of the principal contractual clauses. A copy of the Agreement is available for inspection should this be required. Some clauses show an unusual degree of precision in their terms. The Agreement shows the commonly observed bias towards specifying conditions covering the franchisee's obligations: 21 of these are directly cited compared with 12 for the franchisor.

The Agreement grants the use of Midas's trade marks and systems to the franchisee for a period of five years. The term is renewable subject to the franchisor being satisfied with the franchisee's performance, including the upkeep of his premises. The grant is specific to the franchisee's location but no surrounding territory is awarded. No lump-sum fee is charged for renewal.

The franchisor's obligations are stated in very general terms. He must be available for consultation and advice, and must make standard premises, designs and operating manuals available for the franchisee's use. He

also undertakes to use 'best endeavours' to build up the brand through national advertising. Expenditure on this advertising is left to the franchisor's discretion. Midas pays the cost of training franchisees, excluding travel and subsistence. The franchisee agrees to use the franchisor's designs for his site layout and to abide by the operating procedures that are laid down in franchise manuals. He must not sell unauthorised products or use unapproved equipment. Trademarked display items and signs must be used in a manner which does not dilute the brand image. The franchisee undertakes to exercise his 'best endeavours' in diligently building his business.

He agrees to give the franchisor access to customers for the purpose of checking standards of workmanship. The franchisee also must send a copy of every invoice to Midas's head offices. The franchisor is to hold the title to any telephone lines but all bills for these will be paid by the franchisee. The franchisee undertakes to have no other business interests without the franchisor's consent.

The franchisee agrees to attend training courses provided for him and to send his site manager, if any, to these. In addition, he must co-operate with advertising campaigns mounted by Midas. He also agrees to take at least two inventories of stock and to have drawn up at least two sets of audited accounts each year, and to send copies of final reports of these to the franchisor.

A lump-sum franchise fee and a continuing royalty payment are written into blank spaces in the Agreement. These are currently (1987) £10,000 for the lump sum and 6% for the royalty. In addition a further 6% is levied to pay for the franchisor's advertising. The amounts carry an additional VAT charge which the franchisee may reclaim from the authorities. The royalty and advertising levy

are charged on sales revenue less VAT and must be paid on the Tuesday of each week. Overdue payments incur a 2% per month interest charge.

The franchisee agrees to take out "adequate" property, public-liability, and employer-liability insurance. Precise amounts are not specified. The franchisee is responsible for parts and labour guarantees which he must issue to customers.

The franchise is transferrable with the franchisor's consent. If he sells, the franchisee must pay Midas 5% of the agreed sale price. The term which is transferred must be greater than or equal to any unexpired portion of the Agreement but less than or equal to any unexpired portion of any attached property lease.

The franchisor may terminate the Agreement for breaches of its terms by the franchisee. Breaches of quality requirements result in 72-days notice of termination during which time the franchisee may rectify matters. If the franchisee becomes insolvent or fails to make payments, the franchisor may terminate without notice. Any other breach is followed by 30-days notice which is also rectifiable as in the case of matters of quality. As consequences of termination, the franchisee must cease trading under the Midas name and return all trademarked items. There is a professional-limitation clause [18c(i)] which stops the franchisee from competing within one mile of his site for two years following termination: this makes any local personal goodwill worthless to the franchisee should he leave.

The franchise may be inherited by a franchisee's heirs subject to them meeting the conditions of the earlier clause covering transfer of the franchise. They have 26 weeks to choose to take on or sell the franchise.

3(ii) Implicit aspects of the contract

Mr. Phillips was able to describe a number of business understandings that have grown up within the Midas franchise system. These are treated as implicit aspects of the contract: aspects which rely on the long term value of the franchise relationship to both parties for support.

First, franchisees are always required to take their property leases through Midas. The Agreement is silent on this but it is a condition of entering the network. Mr. Phillips states that this ensures that goodwill built up at a particular site under the brand name remains easily available to the franchisor if the franchisee leaves the system. There are other possibilities here. The franchisor may wish to use periodic rent reviews to extract economic rents from franchisees. Alternatively, he may use lease control to ensure that any leasehold improvements are rendered worthless to the franchisee if he leaves; the lease can be an instrument of increasing the specificity of the franchisee's initial investment. Sometimes a franchisor finds it easier to obtain property than would a franchisee.

Secondly, a territory is conferred on the franchisee. This is allocated in a completely discretionary manner by the franchisor and refers to an area in which no other branch will be located. The Agreement does not refer to this. The franchisor would be tempted to add in a new franchised branch as long as any increase in sales revenue resulted in total to his network. He is constrained from doing this where the franchisee's profits would suffer by a reputation effect that might make franchisee recruitment difficult. A related understanding is that franchisees who perform well are given first refusal on neighbouring new locations as these arise.

A third area of implicit contract concerns in completely defined areas of the franchisor's services to the franchisee. A 6% sales levy is charged to pay for national advertising. Midas must be seen to advertise sufficiently or risk losing franchisees and experiencing recruitment difficulties. The same thing may be said concerning supply lines, if these do not support efficient branch operation then recruitment and retention problems may follow.

A final understanding which emerges below from interviews with franchisees is that additional minor services (like clutch work) may be offered if this supports a franchisee's profitability.

3(iii) Enforcement and monitoring

Mr. Phillips describes the relationship between franchisees and Midas as one of "consultancy". The franchisor does not aim to regularly quote the Agreement at franchisees. Help would always be offered to improve poor performance. Termination of a contract would be a last resort in an extreme situation. There would always be a preference for encouraging the sale of a franchise where the relationship did not work out.

Weekly sales reports are studied and compared with the performance of company outlets. Mr. Phillips believes that a fair idea of attempts to under-report sales would arise from this exercise.

There have been disputes within the network from time to time. Mr. Phillips states that these have been due to poor quality performance by some franchisees. In turn, this may have been due to bad siting. In many cases much managerial support and some debt rescheduling have been used to try and turn situations around. In Midas's

franchising history, there have been three contract terminations and a further three cases where franchisees have "taken the signs down". Two voluntary exits occurred when Agreements came to an end and were not renewed, and one happened with an Agreement still running. The exits arose in cases where Midas had not insisted on control of leases, hence the current practice was adopted.

4. Why franchise?

Mr. Phillips believes that the brand name is the major advantage to franchisees of belonging to the system. In particular, he argues that customers are reassured that they are not dealing with some back-street operator and that there are economies of scale in advertising. These factors mean extra business for the franchisee compared with going it alone. In addition "They can jump the learning curve" and benefit from the franchisor's experience in the business. Also, parts discount and training are better in the system compared with independence.

The major advantage to the franchisor from franchising is perceived by Mr. Phillips to be the local entrepreneurship which is drawn into Midas. He states "There is no way we could get such a high quality of manager at the salary we would pay". It is felt that franchisees are committed to their businesses and work hard developing sales at the local level.

A corollary is that Mr. Phillips believes Midas is saved any need to be involved in the day-to-day running of branches. This can be left to the self interest of franchisees. It is interesting to note that the remains of the company-owned outlets will be in London; they will be concentrated so that supervision costs less.

Mr. Phillips believes there are capital-raising advantages to franchising but that these are not central to the relationship. A copy of one of Midas's advertisements of its franchise opportunity is shown as Appendix K. This demonstrates that Midas emphasises non-capital aspects of the relationship.

Finally, it is thought that franchising encourages honest reporting of business results. A franchisee has a low incentive to under-report sales (the royalty he saves) compared with an employed manager (the entire sales value). Also, the franchisee has much of his wealth sunk into the business and at stake if cheating were discovered.

5. Fees and returns

As mentioned in Section 3 on the contract above, a lump-sum initial franchise fee of £10,000 is charged together with a sales royalty of 6% and an advertising levy of 6% on sales. There are no tied-in sales and no franchisor returns from arranging supply lines. The only additional charge is for lease management. On new leases, Midas asks for a 7% levy on turnover to cover service charges. On some existing leases, the charge has been negotiated as a fixed annual sum which is added to the rent.

Mr. Phillips states that both the lump-sum initial fee and lease service charges are fully spent by Midas. The alternative possibility is that they are used, along with the royalty as devices for transferring economic rent to the franchisor. Any such transfer is fixed at the time an Agreement or lease is issued. Revisions can then only occur at fairly lengthy intervals.

No projections were given by Midas to show how a typical franchisee might perform financially. Mr. Phillips states that returns are above average for Midas and for some franchisees.

The Franchisees

1. Franchisee K₁

K₁ began as a Midas franchisee in XXXX in 1981 in partnership with XXXX. The XXXX franchise was added in 1986 and XXXX was established in 1987. In total, he has 18 employees. All the sites are single-purpose operations selling exhausts, suspension and brake services. Tyres are also carried at XXXX and XXXX. I observed the XXXX site to be a busy, up-to-date, fast-fit establishment. Parts are usually bought from Midas supply lines although occasionally purchases have been made, with approval, from other sources.

K₁ sees his obligations as running his business as successfully as possible whilst fitting in with Midas's corporate identity. In return, he expects Midas to obtain good parts' discounts and to provide management support. He describes their performance as "Reasonable but not in the first rank". K₁ believes that he offers Midas a much more committed local business effort than they could achieve with a paid manager. He does not believe that he benefits greatly from the brand name at his local level. He is enthusiastic about franchising and understood when he started that new-business failure rates are lower for franchised businesses.

The franchisee confirms the structural details of the franchise system described by Mr. Phillips. In addition he is able to illuminate some aspects of practices with leases. Many franchisees stopped paying their fees in

1983 over the franchisor's wish to impose a 7% turnover levy as a lease service charge. This was considered too high. There was "A lot of aggravation" between 1983 and 1984, not just over leases but because franchisees perceived a lack of support. Some franchisees left but lease-management charges did come down. K₁ now faces a fixed service charge of £1,000 a year. He understands that Midas is still looking for the 7% on new franchises.

K₁ is also able to add information on some implicit aspects of the contract. First, he is not aware that he has any territory however loosely this could be defined. He also adds that the Agreement is loosely interpreted: for example, late payments are simply tolerated in many instances. Finally, there was originally a 5% mark-up on parts bought through Midas supply lines, with all paperwork going through head office (as with the Garage Door Company described in Case B). The franchisees successfully had this practice abolished; among other things, it implied extra paperwork.

Since 1984, K₁ has enjoyed "above average" business returns. He intends to remain with Midas. K₁ believes that his initial fee would have been spent by the franchisor in setting up his business.

2. Franchisee K:

K₂ established his franchised outlet in 1981 in partnership and using redundancy money. His XXXX site is a busy fast-fit operation with a wide range of services showing common dependency on the use of inspection ramps: exhausts, brakes, suspension work and clutch replacement. He has three employees on his single-use site. His clutch work is not standard for Midas outlets but is permitted by the franchisor. Components mostly come from Midas supply

lines but sometimes he uses other sources with the franchisor's approval.

He sees his obligations as paying his royalty and making his business as successful as possible. He expects Midas to negotiate good discounts on quality parts. K₂ feels that the franchisor's brand name was important at the start of his business but that his own local reputation is now relatively high so that it has become less important. He believes that his quality of local business management exceeds what the franchisor could get from a paid manager. His major investment gives him a strong incentive to succeed.

K₂ confirms the structural details of the franchise system described by Mr. Phillips. He is also able to throw light on some of the changes that have evolved in implicit aspects of the contract. He reports that it was the franchisees' "united front", which they presented through their association, that successfully fought off the 5% handling charge on parts purchases. He also points to his own interesting experience concerning the lease. When this came due for renewal, Midas claimed that the ultimate landlord (Petrofina) wanted £13,000 a year. Subsequent negotiation reduced the figure to £11,000, suggesting that Midas had tried to extract some economic rent. It happens that the rent was not really there: until 1984 the business was not profitable and then only became just profitable.

However, K₂ speaks well of Midas, pointing out that for three years his debts were often tolerated. In general, the franchisor is not heavy handed in enforcing the Franchise Agreement. K₂ is aware of an understanding over territory. This is "vague" and often not relevant. In one case a franchisee was offered first refusal on a

neighbouring site which affects his sales but could not afford the investment.

K₂ believes that Midas must have made profit out of his initial fee, basing this view on his knowledge of industry costs.

His business is growing in profitability and he intends to stay with the system.

3. K₃, Manageress, Hall Green

The XXXX franchisee turned out to be unavailable for interview so his manageress stood in. It is illustrative to compare the data K₃ could supply, which is largely about structural aspects of the local business, with the more relational data given by franchisees. In a way, this reassures that generally, the correct people have been approached. Also, an extra category of data is provided covering staff employed by franchisees.

The franchisee established his business in 1981. It sells suspension, exhaust, brake, clutch and steering rack services. K₃ has been with the business since 1982 and handles most of the administration. Parts are mostly purchased through Midas's supply lines except for the steering-rack and clutch work which are not standard. All components and the services offered are approved by Midas. There are five employees.

K₃ is unable to comment on the franchisor's or franchisee's expectations of each other, or about explicit and implicit contractual details. She is able to comment on the franchisor's day-to-day involvement with the branch, and has the impression that this is minimal. Apart from monthly visits from head office the branch has

"Not much to do with Midas". Relations seem harmonious. Furthermore, employees perceive little difference between working for a franchisee and working for a company established in its own brand name. Working for a franchisee is thought to be more secure than working for an independent businessman; the brand name is valued by employees.

Company Outlet

K₄, Manager, Midas company-owned outlet

K₄ manages a company-owned outlet in XXXX and wishes not to be identified in the study. Superficially this shows no differences compared with franchised outlets. Trademarked items and layout are identical as might be expected from reaching the Agreement used with franchisees. This branch sells brake, tyre, suspension, and exhaust services. All supplies come directly from makers on company supply lines. As with the franchises, there are procedure manuals and training courses.

However, there are differences. K₄ sees an area manager two or three times a week rather than just once a month. He states that he cannot try new ideas quickly but must refer them back to the centre for approval. Local initiative is "slowed down". K₄'s observations support Mr. Phillips' assertion that franchising removes many monitoring and other management costs for Midas.

Summary

Midas operates a franchise system which supplies brand-name, parts-buying and management services to franchisees. Of these, the franchisees value the parts

services and, surprisingly, do not emphasise brand-name aspects. There are company-owned outlets.

A number of instruments for redirecting profits to the franchisor's end of the business exist. These are the lump-sum fee, royalties, an advertising levy, and lease charges. Franchisees must take their leases through the franchisor. Once these instruments are set in the Agreement or a lease document, there is no scope for variation until renewal dates arise. There is some evidence in this case for the view that the franchisor has been attempting to discover the value of his franchise services by varying lease and other changes until franchisee protests set an appropriate level for these.

The franchisees have not been especially profitable. One reflection of this is the extra lines carried by some franchisees' and simply tolerated by the franchisor. Another is the tolerance shown to some franchisees' debts.

----- Subject to franchisee choice

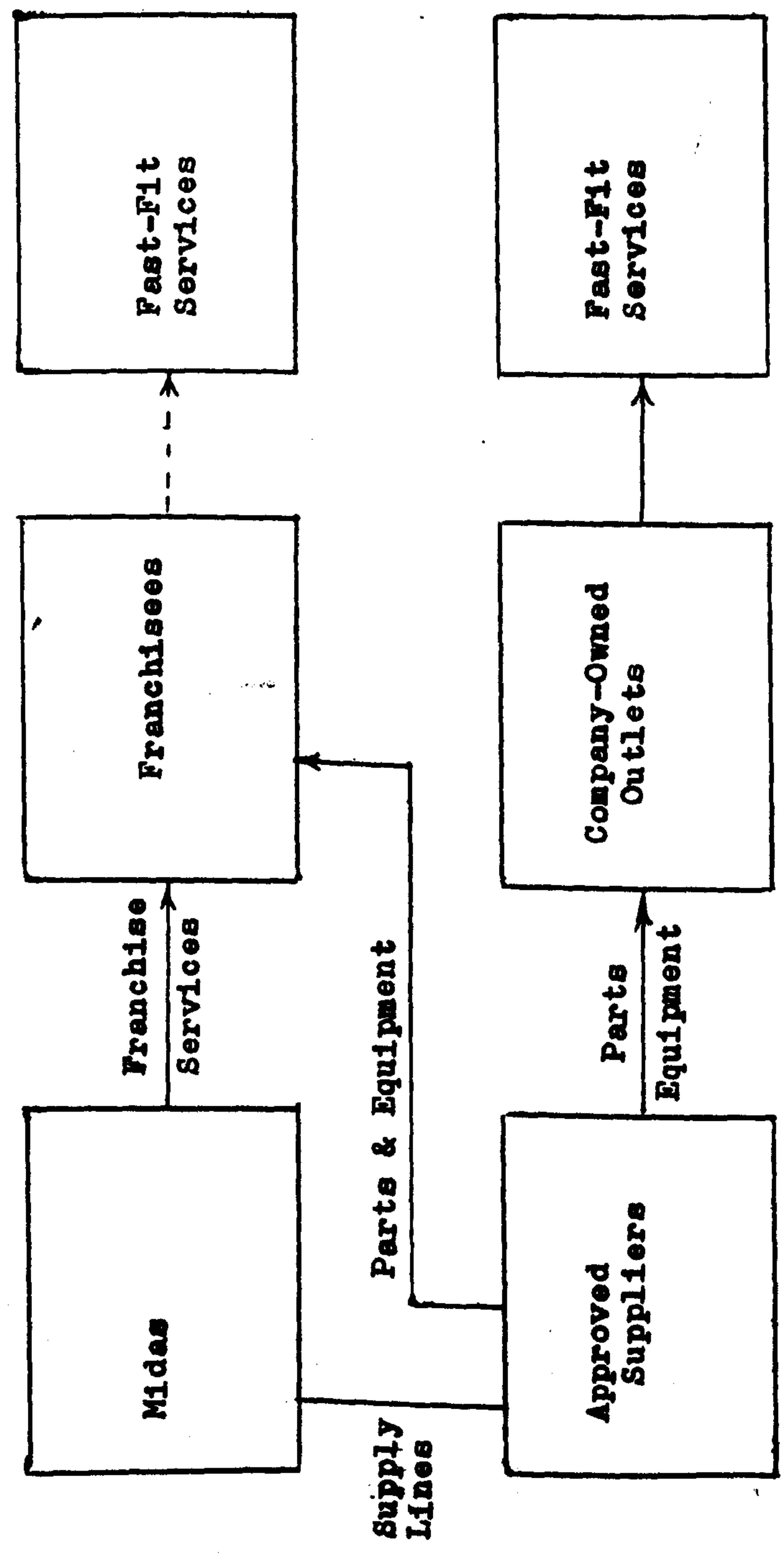


Figure K. Midas (Great Britain) Franchise System

RUN YOUR OWN BUSINESS

(WITH A LITTLE HELP FROM THE WORLD'S LARGEST EXHAUST AND BRAKE SPECIALISTS).

Midas are the world's largest specialists in brakes, exhausts and under-car servicing. A large part of this business is conducted through a highly successful franchising operation.

Midas's U.K. business is growing fast, and they're now looking for franchisees both to take over existing Midas centres and to start, own and run new centres from scratch.

You could buy into an already profitable centre; we currently have opportunities at **Leicester, Burton, Blackpool, Walsall, Longbridge, Cheltenham, Gloucester, Barnstaple, Weston-super-Mare, Exeter, Hendon and New Cross.**

Alternatively, you might already own a garage, whose potential you could expand. Or you might own a suitable site or property which could be developed into a centre.

While you'll need finance, we're not looking for financiers. We're looking for people who are prepared to take an active day-to-day part in the running of their business. Our success is based on the quality of our service, and we'll expect you to implement this. In return, we'll give you all the training, back-up and advice you need.

The challenge is considerable, but so too can be the rewards: you'll be taking part in an established and profitable success story.

If you're up to the Midas challenge, write to:

**Mr K Phillips, Marketing Manager, Midas (Great Britain) Limited,
107 Mortlake High Street, London SW14 8HH.**



EXHAUSTS · BRAKES · TYRES · SHOCK ABSORBERS

CASE L OLIVERS**The franchisor**

Olivers was established in 1982 in Scotland by Ian McKechnie who is a well known Scottish entrepreneur. The first franchise was opened in Elgin in late 1982, although the first shop was a company-owned one opened in Stirling earlier in the year. In 1983, Ladbroke's bought Olivers from Mr. McKechnie and temporarily had a policy of opening company-owned shops, and of taking some back from franchisees. Company policy is now back to franchising but the result of these changes is a chain of 30 shops of which 12 are franchised. Head offices are now in Bedford. In 1987, and after interviewing Mr. Allan (below) Paradise Holdings took over Olivers.

Some shops are straightforward bread shops. Others, and all franchises, are bread and coffee shops. All of them depend on passing trade but would be thought of as traditional cafes rather than as fast-food establishments.

Olivers have a total of 450 employees throughout the network. Each franchisee has around 20 full-time-equivalent employees. This gives a total of about 680 people employed throughout the system. Shops are now spread throughout the UK. Olivers is a significant national brand name in UK high streets. The market for eating out is currently growing at 10% a year, according to the Family Expenditure Survey published annually by the Central Statistical Office. Olivers is aiming to expand its franchise network to take advantage of this growth.

The franchisor has a preference for single-site operations and for franchisees not owning too many shops. The brand should not be diluted as it would be with fractional franchising. A multiple franchisee might

become overpowerful within the network, it is feared. Only one franchisee has two shops.

Olivers is a British Franchise Association member. There is a franchisee association which meets thrice yearly.

2. Nature of the franchise

Olivers offers a full business-format franchise with manuals covering all aspects of operations, administration and sales. The franchisees enjoy the benefits of trading under a national brand name. The franchisor provides no product directly but instead negotiates discounts with major food supporters. A central warehouse is used for distribution. A franchise usually contains a bakery and an associated cafe with an attended service.

No finance is offered to franchisees by Olivers. Franchisees are directed to independent bank sources at the start of their enquiries about a franchise. According to franchisees, it costs around £300,000 to start up a franchised cafe with around 90% of this sum being spent on obtaining and adapting a site. Contractual details mean that at least 30% of site-specific expenditure represents sunk investment. Individuals are likely to have a considerable lump of personal wealth at stake in their businesses.

I interviewed Mr. Nick Allan, who is Olivers' Franchise Manager based at Bedford. Mr. Allan sees the franchisee's obligations as "Accepting that the franchisor ultimately knows best" and preserving the corporate image. In return, Olivers gives full training and marketing support to franchisees. Monitoring standards throughout the system is also seen as an important role for the franchisor.

Franchisees always locate on prime high-street sites where premises are difficult to obtain. The franchisor insists that leases are taken through him although this may be needed anyway as high-street landlords are often reluctant to let to small businessmen. Lease control gives Olivers a device which could be used to render some of the franchisee's assets worthless should he choose to leave the network. Also, lease charges could be used to extract economic rent from franchisees. Another advantage to the franchisor is that any goodwill attached to a site remains available to him if he controls the lease and the franchisee leaves. Insistence on head-lease arrangements suggests that they are not just a service to help franchisees obtain high-street sites.

The Olivers' franchise system is illustrated in Figure L, where arrowheads show the direction of sales flows. Nothing in the Franchise Agreement limits the franchisee's normal freedom to choose whether to serve any particular customer.

3. Contract

3(i) The Agreement

Olivers uses a comprehensive Franchise Agreement which runs to 21 tightly written pages and to 31 principal clauses. However, much of the material is verbose and the Agreement is not especially onerous. There now follows an outline of the principal clauses. A copy of the Agreement is available for inspection should this be required.

The franchisee is granted the right to use the trademark and systems of the franchisor at a specified location for a term of 10 years. The territory is detailed. The term is renewable at no additional cost subject to the franchisee's satisfactory performance. The

Agreement shows a slight bias in favour of specifying more of the franchisee's obligations in greater detail than is the case for the franchisor.

The franchisor undertakes to make himself available for consultation by the franchisor at all reasonable times, to make any special ingredients available, to supervise the conversion and fitting out of the franchisee's premises, and to provide franchise manuals covering operating and other procedures. He agrees also to act as an avenue to suppliers who will lease some items of equipment (such as soft-drinks machinery) to the franchisee. He will pay training costs excluding the franchisee's travel and subsistence.

Olivers insists that a franchisee leases his property from them under an head-lease agreement. The Franchise Agreement states that the rent will be simply passed on as the amount charged by the ultimate landlord. The franchisor cannot add to this and cannot therefore use lease charges as a device to extract economic rent from the franchisee.

The franchisee agrees to operate according to systems which are laid down in the franchise manuals. He must use his "best endeavours" to build up his business and will undertake any training that the franchisor requires. The franchisor's prices are to be used as maximum ones. The franchisee agrees to pay the rent on telephone lines that are in the franchisor's name at the franchised outlet. He also accepts the franchisor's right to contact customers in order to check on standards. The franchisee will show his business to other potential franchisees who are directed to him. He will use only approved sources for his supplies.

There is a £10,000 lump-sum franchise fee paid when the franchisee joins the system. In addition, he must pay a 6% royalty which is due on the Tuesday of each week and is calculated on gross sales receipts less VAT. Late payments attract interest at 2% a month. An unusual feature is that Olivers may estimate overdue payments where sales are not declared; the estimate is to be based on the last sales data submitted plus no more than a 25% increase. The franchisee is to use proper accounting procedures and to submit a profit and loss account to Olivers each month. All franchise fees attract VAT charges which the franchisee may claim back from the authorities.

The franchisee's local advertising is at his discretion, and is subject to franchisor approval of its details. A 2% levy on gross sales is paid to the franchisor towards national advertising costs (this is not charged in practice). The franchisor must issue annual audited accounts of his disposition of such sums.

The franchisee must take insurance that the franchisor arranges on his behalf covering the franchisee's property and liabilities to the public and to employees. He agrees not to have other business interests without the franchisor's consent.

The franchise may be sold with the franchisor's approval of any buyer. 5% of the sale price is passed to the franchisor, who anyway has first refusal at the proposed price.

In the event of the franchisee's death, beneficiaries have 26 weeks to decide whether to take on or sell the franchise. Sale again implies the requirement for the franchisor's approval and to offer him first refusal. The franchisor will provide a temporary manager if so

requested at cost plus statutory overheads. If the beneficiaries do not resolve matters within the 26 weeks, the franchisor can terminate the Agreement and buy back the franchise at 20% below its market value. Disputes over valuation are subject to a compulsory arbitration clause.

The franchisor may terminate the Agreement with 48-hours notice in the case of the franchisee's failure to correct defective products that he has sold. Any other defect to do with the quality of the franchisee's performance may result in the franchisor issuing 10-days notice. These notice periods enable the franchisee to correct any deficiency providing no repeat situation is involved. Termination without notice is implied by the franchisee's insolvency, any misrepresentations he has made, or any disclosures of know-how to unauthorised persons.

The consequences of termination (and presumably of non-renewal of the Agreement by a franchisee) are that the franchisee ceases trading, returns all trademarked items, hands over any customer list, and stops using the telephone lines registered in the franchisor's name. In addition, the franchisee undertakes not to compete within a 12-mile radius of his old location, and within a 13-mile radius of any Olivers' location for two years following his leaving the system. This last consequence means that any local business goodwill is worthless to the franchisee should he leave voluntarily or otherwise.

If the franchisee complies with termination consequences, the franchisor will return a proportion of his initial investment. A scale is used starting at 70% if the franchise is a year old and sliding down a further 10% a year for four more years, and then reducing from a figure of 25% in the sixth year at 5% a year to 1% in the

10th year. This reduces the amount of sunk investment made by the franchisee at the start. Disputes in this region of the Agreement are also referred to compulsory arbitration.

There are technical clauses: non-exercise of a franchisor's right does not imply its waiver; clauses are severable; the franchisor does not guarantee results; and the franchisee must not make unauthorised warranties. The franchisor is free to sell his business. Compulsory arbitration is subject to the rules of the Chartered Institute of Arbitrators. No details are given of the allocation of arbitration costs.

3(ii) Implicit aspects of the contract

Mr. Allan is able to describe business understandings that have emerged over time. These depend on market sanctions and the long-term value of the franchise relationship for their support and are here treated as implicit aspects of the contract.

First, Olivers has agreed with franchisees not to take the 2% advertising levy detailed in the Agreement. This has been reduced to 1% following discussions with franchisees through their association. As part of this, the franchisor now has discretion over his advertising expenditure. Olivers has agreed to this rather than disrupt the long-term value of the franchise relationship.

Secondly, the franchise royalty is not paid if projected profits do not materialise for a franchisee. One franchisee has not paid royalty for two years. The franchisor is worried about the bad reputation effect that franchisee failure would have on recruitment.

Finally, it is normally expected that franchisees will purchase products from approved supply lines, passing all bills through head office where they incur a 5% handling charge. The Agreement has nothing on this. Franchisees often find the arrangement economical anyway. However, purchases away from Olivers' supply lines are tolerated if there are "good reasons" for this. The franchisor will not insist on uniformity to the extent of putting serious obstacles in the way of franchisees' profitability.

3(iii) Monitoring and enforcement

Sales are monitored through weekly notification by franchisees. Mr. Allan believes that Olivers' experience of operating shops helps in assessing the truth of these reports. Also, he believes that franchising gives more incentive to honest reporting: the franchisee benefits only by the royalty he saves from under-reporting, whereas he risks his entire sunk investment. Visits to franchisees' premises are made by area managers on a weekly basis; these also tend to give a check on performance.

Mr. Allan emphasises that franchisees take up very little management time relative to company-owned shops. Also, given the existence of company-shops, "The marginal cost of supervising franchisees is very low".

Olivers aims to avoid quoting the Agreement and tries to avoid a reputation for heavy handedness in dealing with franchisees. There have been some disputes when a few franchisees have either not paid rents or have not paid royalties. There have been one termination and one amicable separation since 1981. Generally, relations are harmonious apart from occasional gripes about particular pieces of advertising.

4. Why franchise?

Mr. Allan believes that franchisees benefit from the brand name above all else, especially in Scotland where it is better known. In addition, leases are easier to come by, shop fitting experience is to hand, and extensive management expertise is available. The supply lines established for franchisees are also of value to them.

The franchisor believes that franchising brings in a committed local entrepreneur in place of the employed manager. The large personal investment followed by years of hard work ensures that franchisees have every incentive to succeed. Mr. Allan can be very precise about the benefits from this as he has recently mounted some market research. In a comparison of franchised and company shops, customers perceive better service, product quality and value for money in franchised outlets. A summary of this market research is given in Appendix L.

Management cost savings are more important the more distant from head office is an outlet, according to Mr. Allan. There is a "slight tendency" for franchised cafes to be in the North. The long-term plan is to increase franchising regardless of location.

Finally, the franchisor does perceive capital-raising advantages but does not regard these as a central reason for franchising.

5. Franchising fees and returns

As described in the section on contract, a £10,000 franchise fee is charged as an initial lump sum along with a 6% sales royalty. In addition, there is a 1% levy for advertising and a 5% handling charge on bills, both of which are governed by the implicit contract. Mr. Allan

states that there is no profit element for Olivers in either the lump-sum, advertising or handling charges.

Sales targets are set at the time of a business projection for a site. Many franchisees do a lot better. No projections were provided for this study.

The franchisor and some franchisees are "very happy" with profitability. Some franchises are "satisfactory". The terminations were of outlets where a franchisee was "struggling". Franchisees support this description.

The franchisees

1. Franchisee L₁

L₁ established his XXXX business in 1984 and expanded into XXXX in 1986. Both are coffee shops and bakeries. In general, he believes it is not practical to run more than one franchise; his are close together and therefore are easier for him to supervise. He has the equivalent of about 40 full-time staff; also, all of his family are employed in the businesses.

He sees his obligation to Olivers as making his business "As successful as possible". As long as this happens both he and the franchisor should be happy. He expects full marketing and managerial support in return for this. The main benefit from belonging to the system is the franchisor's buying power with suppliers. The supply lines have been "Very good" in the past although there have been recent price increases. Moreover, central negotiations save a lot of buying time on his part.

L₁ confirms the structural details of the franchise reported by Mr. Allan. He is also able to clarify some of the implicit aspects of the contract.

His understanding is that there are no tied-in sales. This corresponds with Mr. Allan's statement that the idea of approved suppliers is interpreted loosely. L₁ uses central supply lines as long as they prove cheaper and more convenient. He states that when Ladbroke's took over Olivers a central warehouse was built to handle supplies to franchisees. This persists, in Ladbroke's ownership, even though Olivers has again been sold (to Paradise).

L₁ accepts that the franchisor is not heavy handed in interpreting the Franchise Agreement. The network has not always been harmonious as successive ownership changes have occurred. There have been franchisee worries about opportunities for consultation with head office, product development and advertising. The worry that there was too little advertising of the right quality led to the reduction in advertising they described above. He confirms that three franchisees have been subjected to legal action over fees; one reached an amicable agreement before court.

L₁ states that his returns are good being "Better than money in the bank". He intends to remain a franchisee and has enjoyed business growth in opening his second shop. He is Scottish representative for the franchisee association. He appreciates that he could retrieve little of his initial investment if he were to leave, given that the lease is held by the franchisor.

2. Franchisee L₂

L₂ established his coffee shop and bakery in 1985 having had an interest in becoming a businessman since the 1970s. His business is an extremely busy one located in XXXX. When we met, in the early afternoon of a weekday, it was difficult to find seating to complete the interview. He employs a total of 56 staff of whom one-

third are full time. He believes that it would be possible for him to add another outlet now that he is established.

He sees his obligations as maintaining standards in relation to the rest of the network and maximising his sales revenue. He expects a full back up from Olivers, particularly over sales advice and over supplies. He feels that a major advantage to being a franchisee is the central supplies facility, which saves him time, and the help he receives in obtaining his lease. He states that his rent would be higher without the backing of a larger company: so really this is a brand-name advantage. He knows that his Agreement means that Olivers must just pass on any property rent charged without any additions.

L₂ is aware of an understanding over territory. He believes that the franchisor has a rough idea of a territory applying to each franchisee even though nothing is written down. He thus feels that any developments of new shops in Dunfermline or Dundee affect his business interests. It is not possible to be sure how far this view is shared by Olivers.

The franchisee confirms the structural details of the system recorded by Mr. Allan. His experience of the franchisor is as an easy-going enforcer of the contract. He has not experienced quotation of the Agreement but knows that this has happened in a very few cases. In general, he argues that "All business is a matter of compromise".

L₂ is very happy with his business returns. These proved to be much better than even the most optimistic projections for his site, once he was past his first year. He believes that Olivers must have spent the lump-sum fee

in setting his business up. As mentioned he now wishes to expand and will certainly remain in the system.

Company-owned outlet

Manageress L₃

L₃, who wishes to remain anonymous, granted an interview in order to allow some comparisons to be made between company-owned outlets and franchised ones. The XXXX outlet was franchised for two and one-half years before 1984. Then it was taken back into company ownership during the policy change discussed at the beginning of this case. It stands on a busy site in XXXX near XXXX's central station. It consists of a coffee shop and bakery. There are 25 full-time staff.

L₃ states that she sees her area manager at least once a week although contact may be daily quite regularly. She must make weekly sales reports just like a franchisee. No visible differences exist between the XXXX cafe and franchised ones and L₃ argues that there are none. She uses the same company supply lines that supply franchisees.

Differences do exist. Franchisees see area management less frequently. L₃ is also aware that market research is tending to support franchised operations. As a Company manageress, she is keen to encourage the highest standards within her shop.

Summary

Olivers is a coffee-shop and bakery operation which has experienced alternating phases of enthusiasm for franchising and for company-owned operations. Ownership has changed and the originating entrepreneur for the

business has moved on. The company is currently expanding franchising and points to its market research showing increased customer perception of value for money to justify this.

Franchisees may obtain some brand-name benefits even if these arise in terms of more easily and cheaply obtained central supply lines; these are not tied in but are freely used. Because of a curious history of ownership changes these supply lines are owned (by Ladbroke's) separately from Olivers.

The franchisor has a number of devices available to extract economic rent from franchisees. He sets a lump-sum initial fee, a sales royalty, an advertising levy and a handling charge for supply lines. All except the handling charge, which is only governed by an understanding, cannot be easily varied upwards once Agreements have been signed. There is some evidence that the lump sum is spent by the franchisor in setting up a new franchisee. Lease charges must be passed on at cost.

The value of leasehold improvements may be partly recovered by franchisees if they leave the system. Nevertheless, they sink a substantial investment.

----- subject to franchisee choice

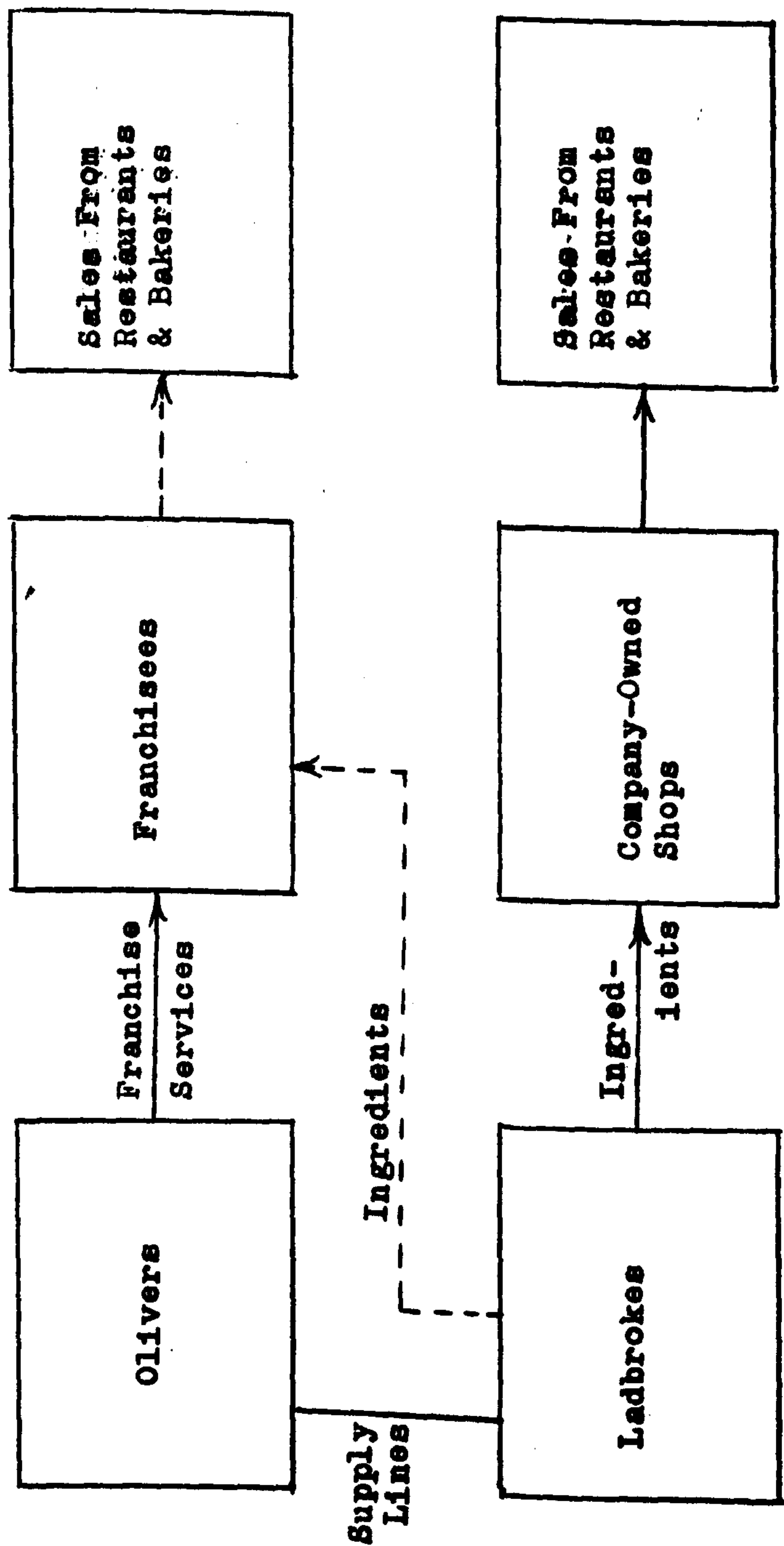


Figure L Olivers Franchise System

Appendix L Results of Olivers's Market Research

| Franchise (%) Company (%) | Excellent | Good | Fair | Poor* |
|------------------------------|-----------|----------|----------|----------|
| Quality of Food & Drink | 40 29 | 39 39 | 13 19 | 8 13 |
| Staff Helpfulness | 29 18 | 35 32 | 21 30 | 15 20 |
| Service Speed | 36 22 | 39 38 | 15 22 | 10 18 |
| Value for Money | 15 10 | 29 25 | 28 30 | 28 35 |
| Cleanliness | 41 33 | 37 19 | 15 25 | 7 23 |

*Includes those with no opinion

CASE M QUIKFRAME

The franchisor1. Background

Quikframe was established in Edinburgh in 1984 by David Peacock. The business uses modern equipment to frame pictures without the use of specialist craftsmen. Following the pilot operation in 1984, three franchisees were recruited. In addition to these outlets, Mr. Peacock ran a second shop, which failed, in Edinburgh for a period of five months in 1985. This franchise has not been a success. At the time of interview, Mr. Peacock spoke of difficulties with his franchisees. Subsequently it emerged that they have left the system and that the network has broken up. Currently (1987) Mr. Peacock runs his Edinburgh shop. The franchisees continue to run under the Quikframe trademark but independently due to an unusual legal situation which is explained below.

The markets for this type of service are the passing high-street retail trade and contract work for local authorities and architects. The competitive advantage possessed by Quikframe, and similar companies like Fastframe, is that a picture-framing job can be turned around within an hour. Traditional methods can take weeks.

All of the franchisees operated single site shops, although one was contiguous to the franchisee's art shop. The franchisor has a preference for single-site operations as he believes this provides a clear incentive for a franchisee.

Quikframe is not a British Franchise Association member. There is no franchisee association.

2. Nature of the franchise

A franchisee buys the right to use a trademark and must take his equipment and supplies from the franchisor. Prior to the start of business, the franchisee is trained in techniques of using the specialised equipment. His business is on the small side and might employ three staff. No estimates are available of the initial cost of starting up a franchise. Some of this would not be sunk expenditure as the franchisee controls his own lease on the premises; so he could reallocate any leasehold improvements to another business.

Mr. Peacock sees the franchisee's obligations as honouring the Franchise Agreement, seeking maximum sales revenue, and operating as efficiently as possible. In return, he believes that he can offer substantial brand-building marketing support along with a full managerial back up.

Quikframe is a full business-format franchise with manuals covering sales, operating and administrative procedures. No financial assistance is offered to franchisees who must use independent bank sources. The Quikframe franchise system is shown in Figure M, where arrowheads show the direction of sales. Nothing in the franchisee's contract limits his normal freedom to choose whether or not to serve any particular customer.

3. Contract

3(i) The Agreement

Quikframe uses a comprehensive Franchise Agreement running to 18 pages and 19 major clauses. There now follows a simplified outline of the main clauses of the

Agreement. A copy is available for inspection should this be desired.

The franchisee is granted the right to operate under the trademark at a specific site. No surrounding territory is given. The term is for seven years and is renewable at no additional cost subject to the franchisee's satisfactory performance.

The Agreement is not precise in its treatment of the franchisor's obligations. Quikframe must bear the cost of training the franchisee, excluding travel and subsistence. General advice must be made available along with manuals covering all operations. The franchisor will provide equipment and "usables" to the franchisee. Centralised advertising is left at the franchisor's discretion: he is to use his "best endeavours". Quikframe may publish a list of maximum shop prices to be used by franchisees.

The franchisee undertakes to use only Quikframe equipment and other supplies, including his stationery and sales receipts. He agrees to provide access to customers so that the franchisor can assess the quality of his operation. Any complaints must be passed to the franchisor. The franchisee also agrees to take a minimum of £250,000 public-liability insurance and "normal" amounts of property and employer-liability insurance. Weekly sales returns are to be sent to the franchisor. The cost of any Yellow-Pages advertisement for his location is to be paid by the franchisee. Proper accounts must be kept for the franchisor's inspection. The Agreement avoids very general exhortations to the franchisee to do his best.

An initial lump-sum franchise fee of £6,000 is charged along with a 12.5% sales royalty. The royalty is due on weekly gross sales receipts (less VAT). VAT is

charged on all franchise fees and may be reclaimed by a franchisee from the authorities. Overdue payments attract interest at the rate of 0.5%\$ a week.

The franchise may be sold by the franchisee subject to the franchisor's approval of any purchaser. A fee of 5% of the sale price is charged by the franchisor to cover the administration of this. The franchisor has the right to first refusal on the franchise at any price which is offered.

If the franchisee dies or is incapacitated, his representatives or beneficiaries have 28 days to decide whether to take on or sell the franchise. This is then governed by the conditions covering sale of the franchise. If requested, the franchisor will provide a manager at cost plus statutory overheads to assist representatives or beneficiaries of the franchisee, whilst they find a buyer. If after a further six months no buyer has been found then the franchisor has the right to terminate the Agreement or to buy the franchise back at its market value. If the franchisor introduces a buyer to the franchisee an additional 5% of the sale price is charged to cover administration costs.

The franchisor may terminate the Agreement without notice if the franchisee breaches clauses covering protection of the trademark, payment of franchise fees, purchases of equipment and other supplies, sale of the franchise, and the keeping of records. Summary termination may also occur if the franchisee is found to be insolvent. Lesser breaches (for example attempting to solicit the franchisor's employees) entitle the franchisee to 28-days notice during which he may rectify the breach.

The consequences of termination are that the franchisee ceases trading as Quikframe, hands over control

of his telephone lines to the franchisor, returns the manual, and returns trademarked items in exchange for their market value if requested to do so. There is a professional-limitation clause which requires that the franchisee does not compete in any capacity with Quikframe for one year after termination.

There are a number of technical clauses: the clauses are severable; non-exercise of a right does not indicate its waiver by the franchisor; the Agreement is stated to be the entire contract; no agency is conferred on the franchisee; and no guarantees of returns are given by the franchisor. The Agreement is governed by Scottish law.

The Agreement is a relatively straightforward document which is written in plain terms and does not appear particularly onerous. Interestingly, it has turned out to be unenforceable as discussed below.

3(ii) Implicit aspects of the contract

Mr. Peacock believes that informal understandings are dangerous in a franchise relationship. This suggests that he has a preference for using explicit contracted devices. Nevertheless the prices charged for equipment and materials are not specified in the Agreement. Mr. Peacock states that there is no profit for him in these sales which are made to assist franchisees in maintaining uniformity. A requirement that the franchisor should keep prices within reason in relation to market prices appears to be an understanding that is supported by his wish not to disrupt the long-term value of a relationship.

Mr. Peacock is also aware that failure to develop public awareness of his brand could pose problems for the retention and recruitment of franchisees (as indeed it has - see below).

3(iii) Enforcement and monitoring

The franchisor receives a weekly sales report from franchisees. This, together with occasional visits that he makes to franchised shops provides monitoring for him of sales and the quality of franchisees' operations. Mr. Peacock claims that his own experience of running shops gives him a shrewd idea of what should be achieved by a franchisee.

The franchisor does quote the Agreement from time to time in his dealings with franchisees. Disputes have arisen over the methods of advertising used by the franchisor, although no details were forthcoming here. The low rate of growth achieved by Quikframe between 1985 and 1987 has also been of concern to franchisees. Disputes were unresolved at the time of the interview with Mr. Peacock.

Why franchise?

Mr. Peacock believes that franchisees benefit from belonging to a multiple-store operation with a brand name. Also, as franchisor, he has an interest in supporting franchisee activities and is able to provide advice based on his own experience.

He believes that there are no capital-raising advantages to franchising for the franchisor. He describes franchising as "An expensive way to expand a business". Franchising creates economies for the franchisor by reducing monitoring and supervision costs relative to running company-owned shops. Mr. Peacock thinks these benefits are greater the more geographically dispersed a franchise network becomes.

Franchisee entrepreneurship is seen as a problem by Mr. Peacock. It is likely to make them too individualistic when uniformity across the system is required, he thinks. This view may reflect disputes that Mr. Peacock has had with franchisees.

5. Fees and returns

A franchisee pays a lump sum of £6,000 and a sales royalty of 12.5% on gross sales, as detailed in the Agreement. These may be varied to alter the distribution of the economic rent arising at the retail end of the business between the franchisor and franchisee. However, variation can only happen when contracts are renewed. The price of tied-in sales gives a more flexible instrument of rent extraction.

The franchisor states that the lump sum is spent in setting up a new outlet. It is difficult to see how this could be: administrative costs must be approximately those indicated by the lower fees attached to any sale of the franchise; no design services are provided; and no assets are provided by the franchisor.

No sales targets are set for franchisees at present (1987). The franchisor intends to introduce them. Mr. Peacock states that returns are above normal for both the franchisor and franchisee.

The lump sum is a sunk investment from the franchisee's point of view. It is quite unrecoverable should he choose to leave the franchise system. However, little else becomes a sunk cost for the franchisee. He controls his own property and would therefore reallocate leasehold improvements of the general shopfitting kind to other uses.

FranchiseeFranchisee M₁

M₁ has an established art shop in XXXX. Until 1984, he had a total of five shops and a drawing office in Scotland. All except the XXXX shop have been sold off. In late 1984, M₁ decided that space at the front of his shop could be better used as a separate business of some kind. He looked at various options and came across the Quikframe franchise. He established his franchised outlet in February 1987. It has a prominent sign and shopfront and looks very much a separate business.

M₁ thought that the layout and design of the franchisor's model shop in Edinburgh was excellent, and still thinks that the business is complementary to his art shop. Becoming a franchisee meant that he could develop the new use for his site very quickly. He states that he believed that the business could be set up with less initial involvement on his part.

The franchisee asserts that "It soon became apparent that the franchisor's operations were very young and financially unsound". He began quickly to become dissatisfied with his relationship with Quikframe and started to look for ways of ending it. Within two years of starting, M₁ was looking for a way out. In particular, he felt that the franchisor had not built up the brand, that he received little support in his operation, and that returns were poor, given the need to pay a royalty. Training turned out to be available anyway from equipment makers.

M₁ confirms the structural details of the franchise reported by Mr. Peacock. He also states that an

understanding existed over territory whereby the franchisor would not locate another shop in XXXX.

M₁ eventually bought himself out of his Franchise Agreement. In May 1987, he and Mr. Peacock made a net-present-value estimate of the worth of the franchise contract to the franchisor, and negotiated around this figure. M₁ continues to trade under the Quikframe name, but this is "Only until we have time to take down the sign".

The two other franchisees have now also left, according to M₁. After he had bought his way out, one of them discovered that Mr. Peacock had not registered his Franchise Agreements with the Office of Fair Trading under the Fair Trading Act. This means that the Agreement cannot be enforced in law (either side of the border). Consequently, the other franchisees have simply left. It is not known whether they continue to use the franchisor's trademark.

Summary

Quikframe was a franchise system that had little to offer franchisees except for a tradename. The franchisor did not build this and, not surprisingly, ran into difficulties with franchisees all of whom have now left to go independent. Franchisees faced modest sunk costs consisting only of the initial lump sum payment plus any depreciation of their initial investment. A clause of the Agreement restricting the franchisee from competing with the franchise network after leaving it would normally render the franchisee's built-up goodwill worthless to him. As the Agreement turns out to be unenforceable due to a legal oversight, professional limitation does not reinforce sunk investments.

--- subject to franchisee choice

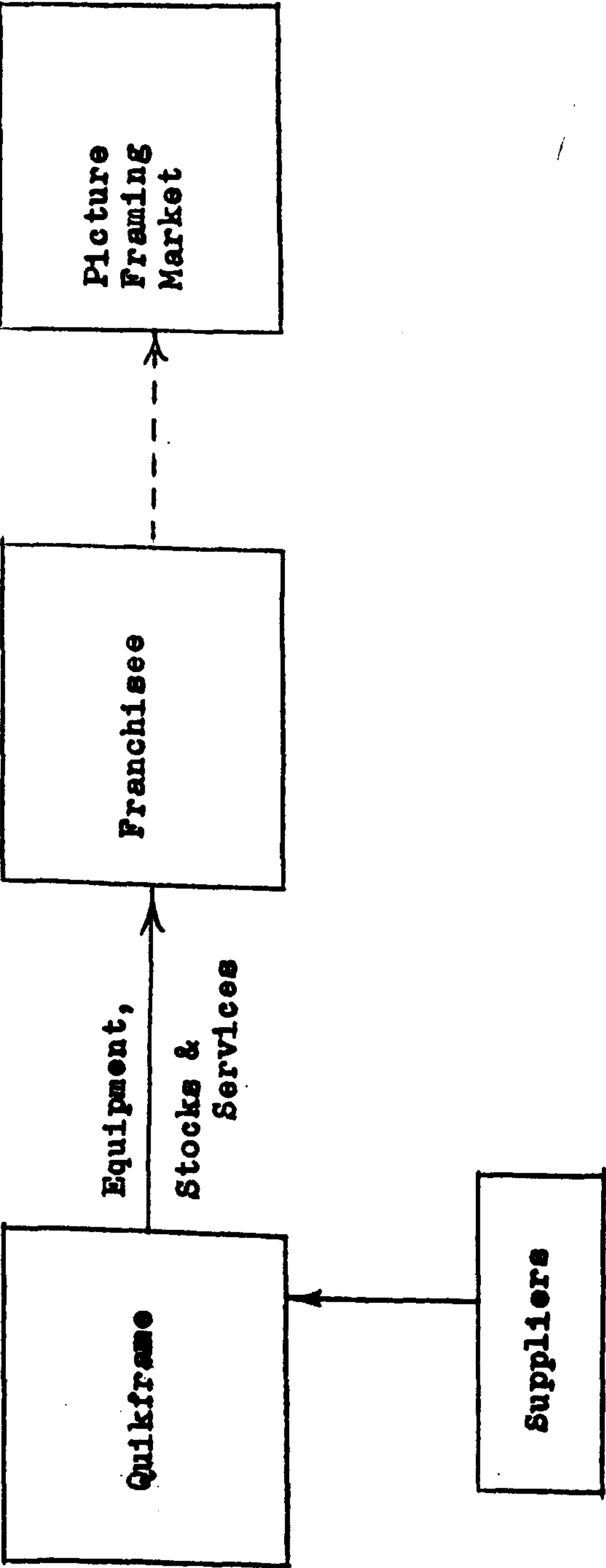


Figure M Quikframe Franchise System

CASE N CURE 30

The franchisor1. Background

Cure 30 Limited was originally set up in 1959 by John and Carole Darley as two separate companies. These were known as the Woodworm and Dry Rot Company Limited and Dampcure Limited. The Darleys ran the companies using direct employees from their head offices in the Watford area. In 1980, they saw a documentary on franchising and decided that this was a good way to organise the business. They now have 43 franchisees operating as branches of Dampcure - Woodcure 30 ("Dampcure" in what follows). A further 25 franchisees work in other subsidiaries of Cure 30 known as Crimecure, Plumbingcure, Electricure, and Plastercure.

Dampcure offers a range of property damp-proofing and timber-preservation services to builders and the general public. Key features are that these are based on chemical products and carry 30-year guarantees. The other franchises offer the specialist services that their names suggest (for example, Crimecure offers security services and began in 1982). Franchisees work from vans operating from either their homes or from small workshops and stores. The franchisor runs all branches in the Watford area as company-owned operations as a means of keeping a check on costs. Otherwise the entire network across all of the companies is franchised. This case study concentrates on the more established Dampcure side of the business.

Each branch of Dampcure has an annual sales turnover of approximately £75,000 giving a total of £3.3 million for the network as a whole. This is run by the franchisor

with a total direct staff of 12 employees (1967). Total employment throughout the network amounts to approximately 150 people. Branches are located throughout England with some concentration in the South East.

Dampcure prefer single-site operations. There are no multiple or fractional franchises. In some cases, Dampcure and Crimecure franchisees operate alongside one another as there are thought to be complimentary in demand for the services; in such cases, they are encouraged to remain separate businesses.

Cure 30 belongs to the British Franchise Association. There is a franchisee association.

2. Nature of the franchise

A franchisee buys the right to operate under the Dampcure tradename at a particular location. In essence, he surveys customer's property, undertakes remedial building work, and injects damp-proofing or pest eradicating fluid into building structures. Materials are bought from sources which must be approved by the franchisor. In the case of chemicals, Dampcure deals with one company, Solignum, and franchisees must buy these products through the franchisor. Mrs. Darley states that this is because of guarantee considerations. Deliveries are direct to franchisees from Solignum. Bills go directly to the franchisee.

Chemical dampcourses and timber treatments are guaranteed for 30 years. The guarantee on materials is from the manufacturer, Solignum. The guarantee on workmanship is provided by the franchisor. Thus the franchisor and Solignum need to be certain that only the approved chemicals have been used. The least-cost means

for Dampcure of establishing this is to insist on tied-in sales.

At the start of his franchised operation, a franchisee receives advertising support from the franchisor, in the shape of Yellow-Pages, local-newspaper and bus advertisements. The franchisor also provides an Amstrad computer and associated business software for some of the systems that the franchisee uses.

Mrs. Darley sees the franchisee's obligations as showing honesty in his operations, maintaining standards of workmanship and being fully committed to building up the business. In return, she aims to give a full managerial back up. Mrs. Darley believes that it is important that she monitors standards of franchisee operations for the good of the network as a whole.

Dampcure offers a full business-format franchise with manuals covering all aspects of operations, sales and administration. There are no highly specific assets initially invested in the business. Franchisees control their own property and until recently the initial lump-sum franchisee fee of £16,000 provided the first three-months lease of a van, all specialist equipment, and initial stocks of chemicals. Most of this would have a reasonable second-hand value. Around £10,000 could be spent by the franchisee on things such as adaption of premises - but again this investment could be moved to other uses.

The Dampcure franchise system is illustrated in Figure N, where arrowheads show the direction of sales flows. It is not known whether the contract restricts the franchisee's normal freedom to choose whether to service any particular contract; this is not likely to be the case and freedom has been assumed in the figure.

3. Contract

3(i) The Franchise Agreement

Dampcure uses a Franchise Agreement with franchisees. Unfortunately, Mrs. Darley is not willing to supply a copy of this for analysis here. Some features are apparent from conversation with Mrs. Darley and with franchisees.

Franchisees pay a lump-sum franchisee fee which was £16,000 until 1987 when it became £9,000; the franchisee then became responsible for more of his initial investment. A sales royalty of 15% is based on the franchisee's gross turnover excluding VAT. The Agreement also specifies a 2.5% levy on turnover as a contribution to the franchisor's central advertising costs. Weekly sales figures must be sent to Dampcure. Full accounts must be submitted every six and twelve months. VAT is paid by the franchisee on all fees but may be reclaimed by him from the authorities. In explaining the change in initial fee, Mrs. Darley states "We were aware of other franchises on the market".

The franchise may be sold subject to Dampcure approving any purchaser. The franchisor may terminate the Agreement if the franchisee breaches it. A professional-limitation clause prevents the franchisee from competing in his old area for a period after termination; this acts to retain all goodwill for the franchisor so that any which properly belongs to the franchisee becomes a sunk investment.

3(ii) Implicit aspects of the contract

Mrs. Darley states that in some instances Dampcure provides more support for franchisees than is required by the Agreement. An example regularly arises when a stand

is mounted at building-trade exhibitions, although this is not specified in the Agreement. This may be understood as an example of the franchisor undertaking brand development motivated by the long term value of retaining and recruiting franchisees.

The Agreement contains nothing which defines territories for franchisees. Dampcure has to consider whether additional franchisees threaten the livelihoods of existing ones in selling franchises. Thus, a tendency simply to sell franchises as long as this benefits the franchisor is controlled by the need to avoid a reputation for poor franchisee support in this respect.

Franchisees are able to point to a further understanding. Since late 1987, the 2.5% advertising levy has not been taken. Representations to the franchisor were made by the franchisees' association. The franchisor makes entirely discretionary expenditures on centralised advertising as a result of losing the levy. Previously, Dampcure paid for a Yellow-Pages advertisement for each franchisee.

3(iii) Enforcement and monitoring

Apart from weekly sales returns which the franchisee must make according to his Agreement, the franchisor has a number of checks on the level of sales achieved. He buys his principal materials for chemical injection from one source which may be monitored to see whether materials consumption is consistent with output levels claimed. The number of Guarantees issued also acts as a check on honest sales reporting. The franchisor also makes occasional inspections of each outlet using a field manager. The experience of operating locally assists Dampcure in assessing the validity of performance reports. Occasional

inspection is the principal means of assessing service quality at the branches.

Mrs. Darley claims that she aims not to be too heavy handed in interpreting the Agreement. Quoting the contract is regarded as a last resort and she generally relies on a process of exhortation to alter undesirable aspects of a franchisee's conduct of his business.

There are few disputes in the network according to Mrs. Darley. These usually revolve around franchisees being late with payments. Only one franchisee's contract has been terminated and this was because he became bankrupt and did not pay his fees.

4. Why franchise?

Mrs. Darley believes that the main advantage to franchisees of belonging to Dampcure is the ability to use the brand name. This works in at least two ways. Firstly, customers are reassured that they are not dealing with some fly by night who may not honour guarantees. This should bring business to the franchisee. Secondly, Dampcure is a member of the relevant trade associations (British Wood Preserving Association, British Chemical Dampcourse Association, and Federation of Master Builders). Franchisees are thus automatically accredited to these and therefore quality for materials guarantees offered by manufacturers.

Mrs. Darley considers training and systems support as lesser but still significant advantages to franchisees.

The main benefit from franchising for Dampcure is perceived to be the quality of local principal operator recruited. This is thought to be much higher than would occur under company-owned outlets. Mrs. Darley believes

that individuals become committed to their own businesses and are more likely to develop local trade as a result.

Another benefit to the franchisor is thought to be that franchising allows specialisation to occur. Dampcure has become expert at marketing and monitoring, whereas franchisees specialise in operations. Mrs. Darley further believes that her monitoring costs are "Much lower than if we ran the branches direct". She agrees that franchisees have an incentive to behave honestly as well as diligently as their business efforts to build their businesses are at stake. If a contract were terminated it could be difficult for a franchisee to raise funds to start in business again; also, he would lose any business goodwill he might have built up due to the professional- limitation clause in the Agreement.

Mrs. Darley does not perceive capital-raising advantages from franchising for the franchisor.

5. Fees and returns

As mentioned above, a £9,000 lump sum is charged for a franchise along with a 15% sales royalty. There are no charges raised by Dampcure for tied-in chemicals. The franchisor just has the lump sum and royalty as relatively inflexible means of shifting any economic rent from the branches to the centre. Mrs Darley states that the lump sum is more than spent by Dampcure in starting up a new franchisee.

The franchisor projects that a franchisee should be able to establish a sales turnover of around £80,000 within two years. Bearing in mind chemical, wage and other costs this would give a franchisee a reasonable income for a small businessman. Mrs. Darley describes net returns to franchisees as "variable".

The franchisees

1. Franchisee N₁

N₁ set up his Dampcure operation in late 1984. He is a sole proprietor and works directly from home. He confirms the structural details of the franchise system reported by Mrs. Darley. He also confirms that he would lose "very little" of his initial investment if he were to leave the network. He has three employees. His business is a busy, home-based, building specialism.

N₁ believes that his obligations to Dampcure are to pay the royalty, to expand his business, and to maintain a high standard of work. In return, he expects instant support over any problem that he encounters. He describes the franchisor's performance in this respect as very good. Training is also described as excellent. He believes that his initial lump-sum fee had little of a profit element in it for the franchisor.

The franchisee confirms that Dampcure is not heavy handed in enforcing the contract: "They have never quoted the Agreement at us and seem fair going". The Darley's look at his books twice a year. N₁ is aware that guarantees act as a check on his sales reports. The only area of dispute he is aware of within the system concerns operating-territory boundaries: the franchisees would like these defined and find the current understanding that the franchisor will consult with them before starting a new franchise too uncertain an arrangement.

N₁ agrees with Mrs. Darley that it is the brand name which is of benefit to him compared with independent operation. It does reassure customers. He does not think that he could provide guarantees on his work if he were on his own.

N₁ is happy with his franchise and believes that his returns are higher than in any option open to him. He intends to stay within the system.

2. Franchisee N₂

N₂ began as a franchisee in late 1982 having previously worked in the timber trade. His business is home based and employs two people. He undertakes the full Dampcure range of damp-proofing and timber-preservation work. He confirms the structural details of the franchise system reported by Mrs. Darley, except that he has an unwritten agreement that he may undertake flood-damage repairs under the brand name but paying just a 5% royalty on the work.

Like N₁, he feels that there are no significant sunk investments in a Dampcure franchise. The most significant item of this type he describes as his efforts in building up the business. He believes that his built-up goodwill would be his major loss if his contract ever ended.: "This gives a major advantage to Dampcure". He believes that the franchisor fully spent the initial fee at the start of his business.

He agrees that the franchisor does not behave in a heavy-handed manner over interpreting the Agreement. Generally, this is not cited. He makes his weekly sales returns and occasionally sees one of the Darleys or a manager. N₂ is generally left to get on with his business without interference. He is aware of concern among franchisees over territories but believes that Dampcure will have to be trusted to see that the franchisor's interest ultimately coincide with those of the franchisees on this issue.

The major advantage of being in the system is being able to use the brand name. This enables him to convince his customers that his is a respectable specialist building company. Guarantees are an important part of this.

He is happy with his business returns at present although he did worry that projections had been set too high at one stage. These are now good, in his view, although not startlingly so. He intends to remain with Dampcure.

Summary

Dampcure is part of the Cure 30 group of companies. An established damp-proofing and timber-preservation business, Dampcure began to make its brand name available to franchisees from the early 1980s.

An initial lump-sum franchisee fee is charged which has been recently revised downwards by allowing franchisees to take care of more of their initial investment for themselves. This could well be a more efficient situation. Franchisees believe that the lump sum contains no real profit for the franchisor. Another area of fees which has been revised is the payment by the franchisee of a contribution towards Dampcure's advertising expenses: this has been abolished in practice. The Agreement appears to have been revised over time. The principal source of the franchisor's returns appears to be the sales royalty, which may be varied with the lump sum as a means of directing economic rent arising in the branches to the centre.

There are few sunk investments that could reinforce the franchisee's consummate performance of his side of the contract. The main example appears to be the goodwill

that he personally builds up in his area. Termination of the contract for whatever reason invokes a clause preventing him from operating in his trade within his area for a period of time. Once he has signed with Dampcure he must remain with them if he is to stay in his line of work. This should strengthen his motivation to make his business a success.

----- Subject to franchisee choice

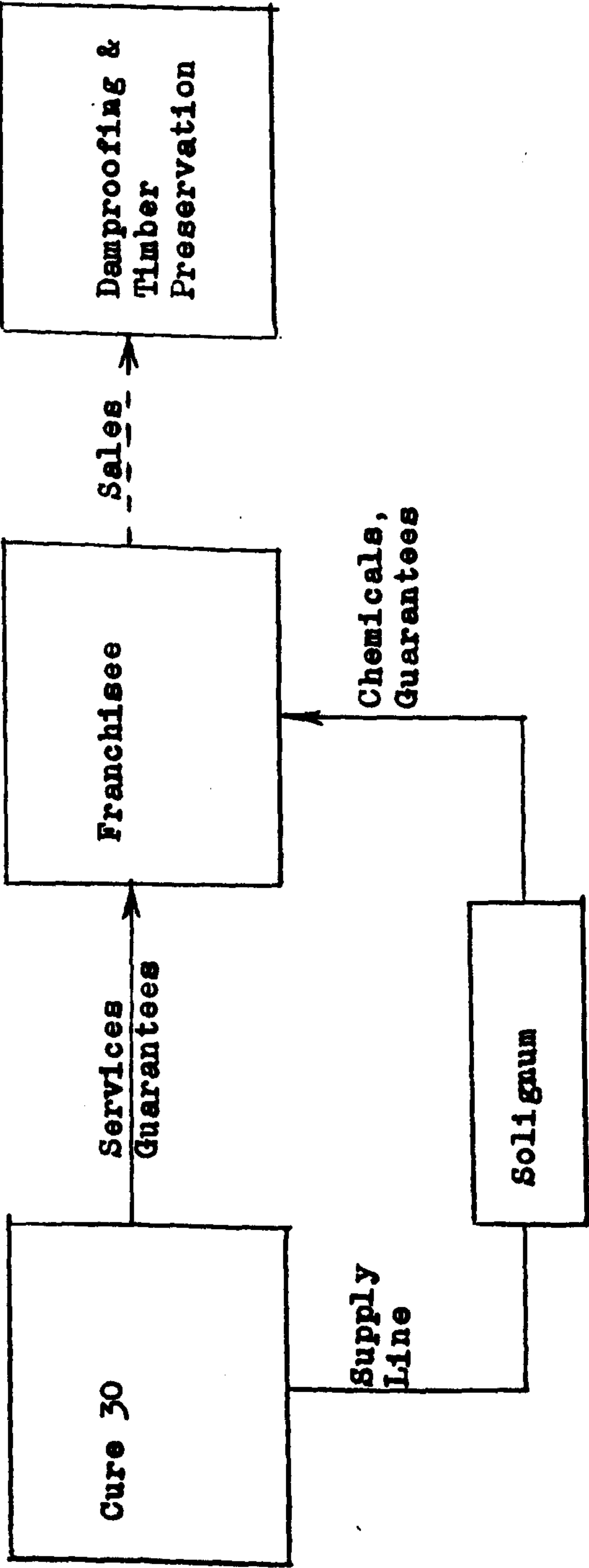


Figure N Cure 30 Franchise System

CASE 0 BARSTOCK**1. Background**

Barstock Limited was established in 1983 as a service which audits stocks once a month for the hotel trade and public houses. An instant-printout computerised system is used. The benefits of this are that licensed traders can check on the honesty of their staff and re-order stocks without spending time stocktaking. Until now, Graham Watson has operated Barstock using direct employees but he now intends to sell franchises starting in 1988. The company is small with three employees working in the field and another two at head office. It operates from Glasgow and is becoming well known locally. The intention is to offer a small-scale franchise that someone could easily start with.

2. Nature of the franchise

Mr. Watson intends to offer a full business-format franchise in which the use of his computer software would be written in to the franchise agreement. The systems would remain his property. A franchisee would operate from a van based at his own home and copy the current service but in other areas. Mr. Watson intends to continue company operations in areas close to Glasgow, where he is already set up and where monitoring is relatively easy for him.

Figure 0 illustrates the franchise system which Mr. Watson intends to create. Arrowheads show the direction of sales flows. No products change hands as Mr. Watson will, offer support services and training to franchisees as the basis of his system. It is assumed in the figure that the franchisee will remain free to choose whether or not to service any particular contract.

Essentially a franchisee will obtain the right to use a brand name which at the moment is of local standing, and to use the franchisor's computerised systems.

3. Contract

3(i) The Agreement

Mr. Watson is currently (1987) constructing the Agreement he intends to use. Only limited details are therefore available.

The franchisor will charge an initial lump-sum fee to reflect the costs of setting up the franchisee. These costs include training (excluding travel and subsistence), computer hardware and software and launch advertising. A continuing royalty will also be charged and will give the franchisor his returns. No property lease arrangements are likely to be relevant to the franchise contract.

Mr. Watson intends the franchise to be saleable by the franchisee subject to his approval of any purchaser. He will also use a professional limitation clause restricting the franchisee's competition with the system for a period after termination or sale of the contract. This will retain any business goodwill within the franchise system.

He intends to use a compulsory-arbitration clause in the Agreement.

3(ii) Implicit aspects of the contract

Mr. Watson anticipates that understandings will emerge between himself and his franchisees. He accepts that business is "Not a question of enforcing the letter of the law but one of give and take" He believes that an

area likely to generate understandings is the creation of territories for franchisees; these are not to be rigidly defined as lines on a map in the agreement.

3(iii) Enforcement and monitoring

Mr. Watson will require franchisees to submit weekly business returns covering sales. From his own experience, he has an idea of what sales should be possible in an area and of the costs attached to these. In addition, a centralised complaints procedure will indirectly act as a check on unreported sales.

The franchisor's expectations over implicit aspects of the contract reported above also suggest that he would not regularly quote the agreement at franchisees.

4. Why franchise?

Mr. Watson believes that franchisees would benefit from working under a brand name that he hopes to build up. He also states that his computerised system is valuable. In addition, he believes that a centralised advertising budget is likely to be more effective in generating business than separate efforts would be.

The main advantage to the franchisor stems from the nature of his business. Mr. Watson states that trust between the final customer and the local operator is very important. The customer needs to feel that the operator is wholly motivated to stem any losses which may be occurring. This is more likely to happen if the operator is a small businessman with a strong incentive to retain business.

Another advantage to the franchisor is that he saves monitoring costs under franchising. Franchisees should be

motivated to give good service as they benefit from the profits which follow this. A franchisee should also be more inclined towards honest reporting of sales results compared with employed operatives. This is because he only saves a sales royalty by under-reporting and risks disrupting his business future.

Mr. Watson perceives capital-raising advantages to franchising for himself. Franchising allows him to make a particular kind of investment and raise capital for his business. He is enabled to invest in an easier-to-monitor network.

Summary

Barstock is a specialised barstocking service offered to the licensed trade. It intends to expand by franchising largely because of the incentive this will provide to franchisees to become committed to good customer service.

It remains to be seen whether Barstock offers a sufficient advantage to franchisees compared with independent operation.

-- -- Subject to franchisee choice

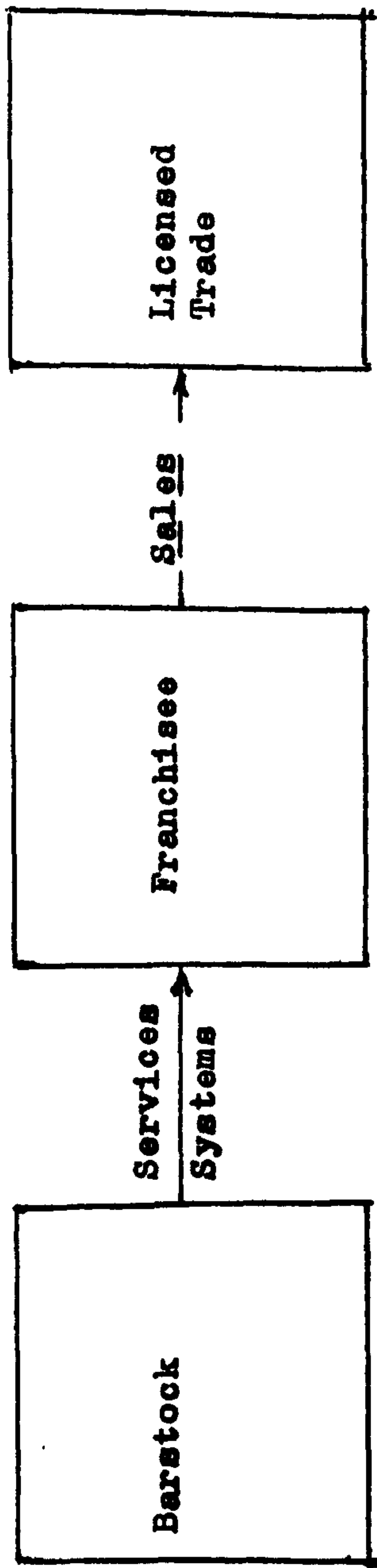


Figure 0 Barstock Franchise System

CASE P COMPUTERLAND

The franchisor

1. Background

Computerland operates 820 outlets worldwide dealing in computer hardware, software, maintenance and training. The company was first established in the USA in 1976, entered European markets in 1980 and came to the UK in 1982. There are 20 shops in France, 20 in Germany, 18 in the UK, 6 in Spain and 2 in Italy. Most of the remainder are in the USA and Japan. In the UK (and Europe) business markets are served, in contrast to the USA where personal and business markets are catered for. Each branch employs around 15 people. The UK is administered from regional offices at Milton Keynes which are ultimately under the control of Computerland S.A. head offices in Luxembourg. This case concentrates on the UK operations.

Computerland belongs to the British Franchise Association. There is an active franchisee association.

Franchising has always been part of Computerland's business philosophy. Virtually all outlets are franchised worldwide; in the UK an exception exists where a branch has been bought back from a franchisee whose business was failing. Multiple franchises are permitted: Scotland has three shops belonging to one franchisee; one London franchisee owns four outlets; Manchester, Birmingham and Salford form a group. No fractional franchises are permitted.

2. Nature of the franchise

The franchisee purchases the right to trade under the Computerland brand name at a particular location. A

territory is conferred on him in the sense that no other branch will be established within a one nautical mile radius. Computerland deals in all of the supplies that a franchisee might want but leaves him free to choose where to buy. In addition a full site-design service is provided at cost by the franchisor at the start up of a new franchised outlet.

I interviewed Caroline Fitz-Gibbon, Computerland's Franchise Operations Manager, at the UK headquarters in Milton Keynes. She sees a franchisee's obligations as paying franchise fees and maintaining operating standards in line with those laid down from time to time by Computerland. In return, the franchisor aims to provide full managerial support of franchisees and to obtain good discounts on supplies.

Computerland offers a full business-format franchise with manuals covering all operating, sales and administrative systems. No financial support is given; franchisees are directed to independent sources of finance like the major banks. Training is at the franchisor's expense (but excludes travel and subsistence costs for the franchisee) if the franchisor requests it.

The Computerland franchise system is illustrated in Figure P, where arrowheads indicate the direction of sales flows. As far as is known, nothing in the franchisee's contract limits his normal freedom to choose whether to supply any particular customer.

A franchisee makes a substantial sunk investment in his business. It costs around £250,000 to set up a medium-sized branch serving a population of between 100,000 to one million people. Approximately one-quarter of this would not be recovered in the event of the business failing. The sunk items are a lump-sum initial

franchise fee, training costs at the start up and a proportion of the cost of making leasehold improvements and adding fixtures to the business premises. There is no control of the lease by the franchisor so the franchisee could reallocate some of his investment in improving his property if the need arose. Nevertheless, the sum of around £60,000 represents a considerable sunk investment which is likely to motivate the franchisee to make a success of his business.

It should be noted that little of the sunk investment is naturally unrecoverable. Around £20,000 worth of the organisational and training costs of the franchisee could be regarded as an investment in creating local business goodwill. These are sunk because the franchisor may take steps to retain all goodwill if the franchisee leaves. Also, the lump sum of up to £25,000 is a further sunk cost which is created by the franchisor.

A copy of the franchisor's projections for the initial investment attached to setting up a unit catering for a population of 100,000 to 1,000,000 is given as Appendix P.

3. Contract

3(i) The Agreement

Computerland uses a detailed Franchise Agreement but was not prepared to provide a copy for analysis in this study. A few details can be gathered from comments of Mrs. Fitz-Gibbon and of franchisees.

A lump-sum initial franchise fee is charged. This varies according to the population targeted for a branch. Currently, this starts at £13,000 if the population is less than 100,000 and at £20,000 otherwise. These sums

are described by Mrs. Fitz-Gibbon as embodying only a modest profit element. In addition, the franchisee pays 3.5% of his sales turnover as a continuing royalty payment and a further 1% as an advertising levy to the franchisor. Turnover is calculated before VAT. However, VAT is added to all franchise fees and may be reclaimed from the authorities by a franchisee. (This careful procedure prevents double counting).

A professional-limitation clause prevents the franchisee from competing with the Computerland system for a period after termination of the Agreement. This keeps all goodwill in an area to the franchisor. The franchise may be sold subject to the franchisor's approval of a prospective purchaser.

3(ii) Implicit aspects of the contract

It is possible to identify at least two business understandings that have grown up within the Computerland franchise system. These rely on the long term value of the franchise relationship for their support.

Computerland appears to accept the need to listen to franchisee's requests for revisions of the written Agreement. In 1987, the franchisees obtained a reduction in the sales royalty from 8% to 3.5%. In return, Computerland was permitted discretion to add a profit element to the prices of product sales to franchisees; previously it was understood that products would be passed over at cost. Franchisees felt that Computerland was not being as vigorous as possible over obtaining discounts and keeping administration costs low on its distribution service. The new arrangements tie the franchisor's rewards more directly to his performance, particularly as franchisees are not obliged to buy products from him.

Secondly, the prices of transferred products must be kept competitive with alternative supply sources. From what has been said already, it is clear that otherwise franchisees will buy elsewhere.

3(iii) Enforcement and monitoring

Mrs. Fitz-Gibbon states that Computerland tries to avoid the need to ever quote the Franchise Agreement by carefully designing the contract to make the franchisee's and franchisor's interests coincide. She accepts that recent contract changes have been the result of "Market pressures from franchisees".

Monthly sales figures are reported by franchisees. Computerland field managers also inspect branches from time to time. The franchisor is confident that wild under-reporting of sales would be detected. The monitoring system is thought to be of sufficiently low cost, as borne out by the small UK head-office staff of five.

The franchisor states that the system runs fairly free of disputes. Occasionally franchisees conflict over sales as territories refer to locations and not to sales. One UK franchisee was inefficient. In addition to these examples, it should be noted that the recent payment schedule changes were essentially the result of a conflict.

Computerland bought out the inefficient franchisee (Southampton) rather than see one of its branches fail. This would have had a bad reputation effect as far as recruitment of franchisees is concerned. Southampton will be re-franchised once a new buyer is found.

4. Why franchise?

Mrs. Fitz-Gibbon believes that a major advantage of being a Computerland franchisee is the ability to use the trade name. The name is well known in business circles due to the company's size in the USA. A second advantage is that franchisees can use each other to support maintenance on sales made away from local markets; there are network advantages. Computerland also believes that product discounts are important and this is supported by recent franchisee actions over royalties. Finally, franchisees are automatically accredited as dealers for certain manufacturers like IBM by being in the Computerland network.

Computerland benefits from having committed local entrepreneurs in the branches. Mrs. Fitz-Gibbon points out that this philosophy is emphasised in some of the publicity literature. One example of this is:

"The commitment of local ownership

Each Computerland centre is owned by individuals so each centre represents a substantial investment by its owner ... you're dealing with the owner - and he's there for the long term".
(Computerland brochure, 1987).

It is believed that franchisees have much more at stake in their branches than any employed manager could ever have.

Mrs. Fitz-Gibbon also states that monitoring costs are judged much lower than would be the case with a company-owned network. The experience of buying back Southampton convinces her of this. The branch has taken up more management time than the entire franchised network.

5. Fees and returns

Franchise fees are reported in Section 3(i) above. These together with the charge for transferred products, are used to divide economic rent between the franchisor and franchisee.

Computerland provided no sales projections for analysis in this study. Mrs. Fitz-Gibbon states that returns are excellent for both franchisees and Computerland.

The franchisees

1. Franchisee P₁

P₁ became a Computerland franchisee in April 1986 having worked as a computer specialist for XXXX. Around 15% of his business is with individuals and the rest is with companies. He buys 40% of his requirements within the UK and 60% from Computerland's warehouse in Luxembourg. There are 12 employees in XXXX. The business is a busy, ultra-modern combined office and showroom.

P₁ sees his main obligations to the franchisor as "Doing everything possible to strengthen the organisation". An example of this commitment arises when he buys products. A rival company, Compro, is often cheaper than Computerland but P₁ will not buy from them. In return, he expects full support from Computerland and, in particular, expects good product discounts.

The franchisee confirms the structural details of the Computerland system recorded by Mrs. Fitz-Gibbon. Additionally, he is able to clarify some aspects of the franchise relationship. The 1% levy on sales which franchisees contribute to the franchisor's marketing costs

is allocated to different promotional methods by a committee of the UK franchisees. The franchisees meet monthly anyway for general purposes; they feel they have been successful in keeping the franchise relationship beneficial from their point of view.

P₁ believes that the brand name is of some value to him as a franchisee. He describes this as worth 1% of his turnover; it is not of major importance. The main benefit to him is that Computerland obtains volume discounts which are then passed on. P₁ believes that he is able to offer local entrepreneurship that Computerland could not get any other way.

Interestingly, P₁ did not read his Agreement nor did he consult a solicitor before becoming a franchisee. He based his decision on a personal assessment of the franchise system and the franchisor's staff. This is astonishing but may be quite shrewd; given that contracts are rarely quoted or legally enforced, the personal aspects are important ones. He confirms that the franchisor does not quote his Agreement to him.

P₁ has experienced very good returns from his business, which was profitable within its first year of operation. He intends to remain with the system. He paid a lump sum of £17,000, which suggests some negotiation from the figures quoted by the franchisor. He believes that there was a profit element in this; he received four-weeks training and store-design services that could not have used up this figure.

He reports that it can be difficult to transfer maintenance work within the system. This has always been possible but the quality of work coming from another branch for his customers could not be guaranteed. There is now a national maintenance agreement which P₁ describes

as "A step in the right direction". This again suggests that the franchisor is prepared to be flexible.

2. Franchisee P₂

P₂ began as a Computerland franchisee in 1983 in XXXX. Branches in XXXX and XXXX were added in 1984. The business was originally a partnership but has operated as XXXX Limited since 1985. 85% of all sales are to large companies. All dealings are with businesses as there is no walk-in trade as there would be in the USA. P₂ has 31 employees spread across sales, engineering, training and administration.

P₂ sees his obligations as paying his royalty and abiding by the spirit of his Agreement. In return he expects "Delivery of the right product at the right price and in good time". His supplies come from Computerland only if this is the cheapest source. P₂ believes that often he can do as well on his own.

The main benefit to belonging to the system is seen as the bulk-buying discounts that can arise. A secondary benefit is the ability to trade under the brand name. P₂ reports that he "Took a gamble that the brand would develop over here" in signing with Computerland. This paid off as there is now a reasonable national presence. The existence of a national chain means that support can be offered to distant customers. P₂ shares P₁'s view of the problems of ensuring the quality of transferred maintenance work.

P₂ confirms the structural details of the Computerland franchise system reported by Mrs. Fitz-Gibbon. He emphasises that franchisees' expectations have changed over time towards regarding the franchisor as a bulk-buying distributor. They have been successful in

making Computerland's rewards more dependent on efficiency at doing this. The franchisor's enforcement of the Agreement is not seen as heavy handed.

Returns are described as very good by P:. He intends to remain a franchisee and looks forward to future expansion. He believes that the initial lump-sum franchise fee contains a profit element for Computerland and bases his assessment on his knowledge of industry setting-up cost conditions.

Summary

In the 1980s Computerland expanded into the UK and Europe using a franchise system which has been developed in the USA. In the UK, the markets served are exclusively business ones. Franchisees appear to enjoy brand-name advantages. The system has settled down into a pattern where the franchisor acts as a bulk-buying distributor for the franchisees and receives returns which are based on performance in this area. A small sales royalty is charged with most of the franchisor's returns coming from a mark up on products that the franchisee is not obliged to buy.

If Computerland performs the bulk-buying service well then economic rent is likely to be created at the retail end of the business. These may be extracted through the lump-sum initial franchise fee, the royalty or the mark up on products. The mark up remains flexible after Agreements have been signed. Franchisees believe that the lump sum has a profit element for the franchisor.

A Computerland franchisee makes a significant sunk investment in his business because of the lump-sum fee and restrictions placed on his business activities if he leaves the system. Professional limitations mean that

initial and continuing investment in creating local business goodwill are lost to the franchisee.

Computerland does not control the leases on franchisees' properties.

----- Subject to franchisee choice

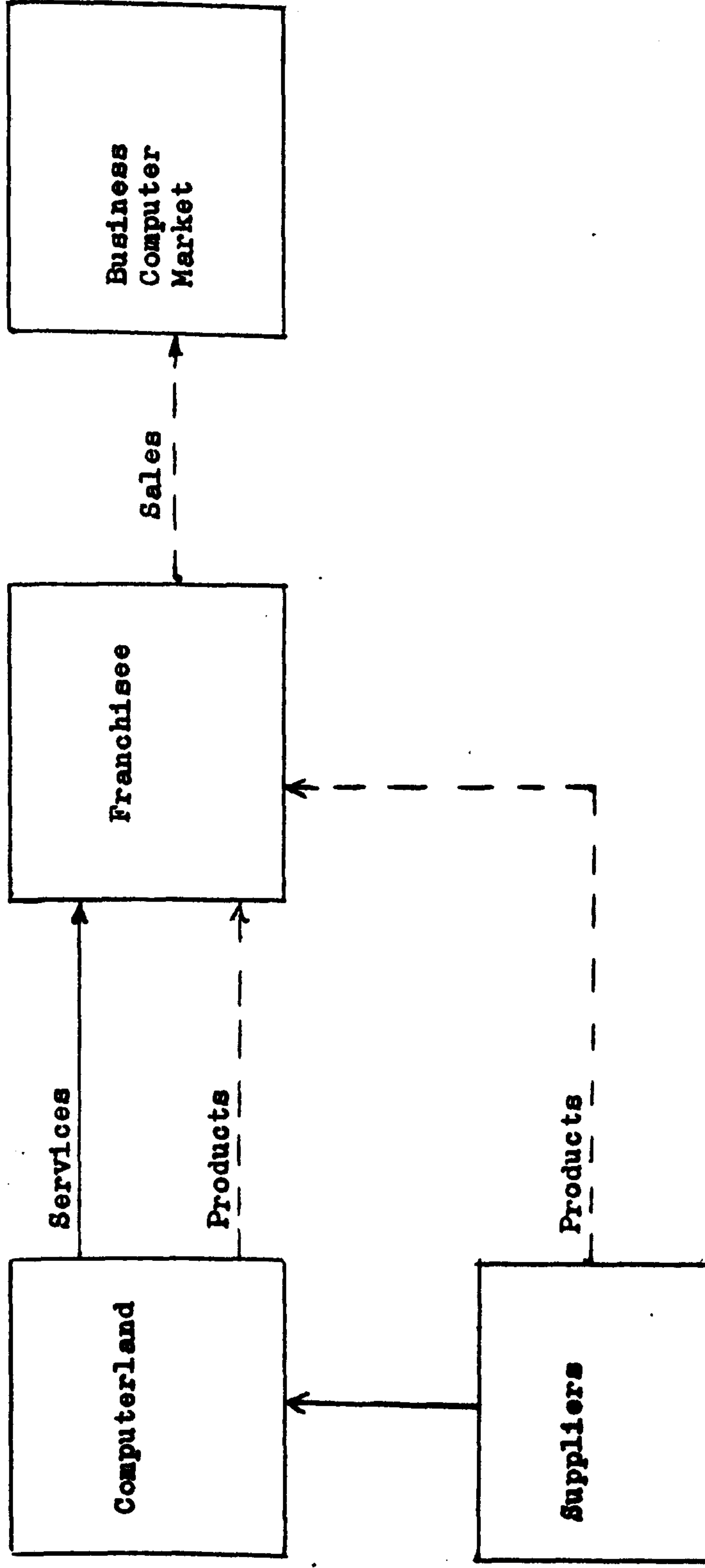


Figure P Computerland (UK) Franchise System

APPENDIX P COMPUTERLAND PROJECTION

Investment, organisation and start-up costs (£'000)
for a medium sized market

| | | |
|---|-----|-------|
| Franchise fee | 20 | |
| Leasehold improvements | 30 | - 40 |
| Fixtures | 15 | - 22 |
| Furniture and equipment | 28 | - 35 |
| Initial stocks | 40 | - 50 |
| Sign and installation | 2 | |
| Working capital | 40 | - 60 |
| Organisational, training and other costs | 20 | - 30 |
| <hr/> | | |
| Capital cost (approximate) | 195 | - 259 |

CASE Q YVES ROCHER**The franchisor****1. Background**

Yves Rocher is a French cosmetics company which was established in 1959. It is named after its founder who still controls the company. There are around 900 shops, 600 of which are in France with the remainder spread mainly around Europe and the UK. Current sales turnover is approximately £400 million (1987). Around 3,000 people are employed directly by the company, mainly in France with another 5,000 or so employed in shops which are almost all franchised. One-half of the total revenue comes from shops with the rest coming from a mail-order business. Mail order does not operate in the UK which now has a chain of 30 franchised shops. This case concentrates on Yves Rocher in the UK.

The business is based on cosmetics which are derived from plants and advertised as natural beauty products. Each franchisee sells these from a shop usually located just off main high streets. Beauty therapy is also offered to women at these locations. The franchise is aimed at female beauticians who wish to open their own businesses; usually if they are married the husband becomes involved on the administrative side.

The franchisor does not permit multiple or fractional franchises. All sites are small stand-alone units.

Yves Rocher is a member of the British Franchise Association. There is no franchisee association.

2. Nature of the franchise

Franchisees receive the right to trade under the Yves Rocher trademark at a particular location. In return for this they pay an initial lump-sum franchise fee and agree to sell only Yves Rocher products. Within each branch a beautician's salon is run under the trademark but without any returns to the franchisor. This is regarded as a good means of bringing in customers by Yves Rocher who are essentially interested in selling products.

Gisle Navacelle is the Managing Director of Yves Rocher (London) Limited, which is a wholly owned subsidiary of the French parent company. He sees franchisees' obligations as buying the product, honouring their contracts, taking advice, and building their businesses. He emphasises that they must be fully committed to their businesses. In return he aims to give full managerial support and promotes the brand. He also considers it important that he polices standards throughout the network to protect both Yves Rocher and franchisees from loss of reputation.

Yves Rocher offers a full business-format franchise with manuals covering sales, operating and administrative procedures. Beautician training is not covered: either the franchisee is already trained or a beautician is hired. A highly standardised shop layout is followed by each franchisee. Property leases are not compulsorily taken through the franchisor; a head-lease arrangement is available if a franchisee finds this helpful to secure her property.

Each shop costs about £54,000 to establish. This consists of expenditure which is for the most part sunk into the business as far as a franchisee is concerned. A

projection of set-up costs provided by Yves Rocher is shown as Appendix Q. If the franchisee controls her own lease then building costs of around £30,000 establish an asset that could be relocated (at some cost) to other uses. The franchise fee is sunk along with furnishing and legal costs into the specific business; these amount to about £24,000. Since Yves Rocher uses a contract containing a professional-limitation clause, local goodwill cannot be retained by the franchisee if the contract is terminated. Since she cannot compete with Yves Rocher in her old area, initial investments in the specific business and subsequent efforts to build it up become sunk expenditures. The franchisee can only sell her business as a going concern with the consent of the franchisor.

Some financial support may be given to franchisees by Yves Rocher. This is discretionary and is given as a subsidy where site costs are very high. Otherwise, franchisees raise funds from independent bank sources. They are assisted in putting together financial plans.

The Yves Rocher franchise system is illustrated in Figure Q, where arrowheads show the direction of sales flows. It is assumed that nothing in the franchisee's contract limits her normal freedom to decide whether or not to deal with any particular customer.

3. The contract

3(i) The Agreement

Yves Rocher uses a detailed Franchise Agreement with franchisees. A copy was not provided for analysis in this study. Nevertheless some details can be gathered from discussions with Mr. Navacelle and with franchisees.

The franchisee pays an initial lump-sum franchise fee of £7,500. This covers training, initial management support, some advertising and store-design services. Mr. Navacelle states that Yves Rocher usually spends more than this in starting up a franchisee. In addition, the Agreement specifies that franchisees will receive a 35% discount on the recommended retail prices of products. There is no sales royalty as such.

The Agreement runs for five years and is renewable provided the franchisee's performance is satisfactory. If the Agreement is terminated, the franchisee cannot compete within his old area for a period. This preserves all goodwill in the hands of the franchisor. The franchise may be sold by the franchisee subject to the franchisor's approval of any purchaser. Territories are linked to postcodes, according to Mr. Navacelle.

3(ii) Implicit aspects of the contract

Mr. Navacelle states that it is understood that Yves Rocher will support a franchisee financially if sales turn out to be significantly below projections for a site. He is aware of the damage to recruitment which could follow from the failure of his franchisees.

A second implicit aspect is advertising. The Agreement specifies only that the franchisor should offer adequate support. Actual amounts, mainly in newspapers and magazines, are not stated. Again, the franchisor is motivated to be seen to be building up the brand by effects on the recruitment and retention of franchisees.

Finally, although the retail mark up for franchisees is specified in the Agreement, list prices are not. It is understood that these are to be sensitive to cost and demand conditions. Franchisees state that sales-revenue

maximisation implies profit maximisation for them (i.e. they are in an output range where costs and revenues are diverging). The franchisor may choose his prices to meet his own objectives, subject to leaving franchisees at least a normal retailing return; they will sell whatever can be sold at any given price.

3(iii) Enforcement and monitoring

Mr. Navacelle does not aim regularly to quote Agreements to franchisees. However, he has a policy of trying to stop contract violations as early as possible. His usual method is exhortation. Termination of an Agreement would be a last resort; some negotiated settlement would be preferred.

Weekly sales returns are made to the franchisor and reinforced by occasional visits to stores. Mr. Navacelle is confident that he would detect any misrepresentation of sales through these means. The tied-in product gives the franchisor a direct connection with the franchisee's performance. The relevant check is to see whether the franchisee is sticking to selling the branded goods. Tied-in sales, retail returns and visits must all point to the amount of business that Mr. Navacelle believes an area can generate. Monitoring costs are felt to be reasonable.

Mr. Navacelle states that there have been occasional disputes within the Yves Rocher system. There are minor disagreements from time to time over particular promotional strategies and over product availability. He knows of only two serious disputes. One franchisee did not pay for his product and had his contract terminated. One franchisee did not achieve the results felt to be possible and a buyer was found for the franchise.

4. Why franchise?

Mr. Navacelle believes that the franchisee's major benefit from belonging to the network is the right to trade under the brand name. This brings business through the doors as many customers know of Yves Rocher from the Continental shops. Also it gives them a stake in the cosmetics business even though they may be small shops. Many major manufacturers like Chanel and Givenchy just do not deal with small businesses.

The franchisor believes that two main benefits follow from franchising. First, the franchisee has personal wealth staked in her business and is more likely to vigorously develop the shop. Mr. Navacelle points out that "Franchisees are part of the local economy". Secondly, there are monitoring cost savings which follow from the greater trust which may be placed upon franchisees, who have no incentive to under-report sales as long as Yves Rocher products retain brand and cost advantages.

Mr. Navacelle believes that there are capital-raising advantages to franchising but that these are not the main reasons for organising along these lines.

5. Fees and returns

The franchisee must pay a £7,500 initial lump-sum franchise fee and buy tied-in products as discussed above.

A typical city shop aims to reach annual sales figures of around £250,000 within three years, according to projections supplied by the franchisor. This gives an annual profit (before interest and tax but allowing for depreciation) of £30,000. This represents an excellent return for a small business in 1987. Mr. Navacelle states

that returns are variable for franchisees but that many do hit their targets. Yves Rocher is itself a successful and profitable company.

The franchisees

1. Franchisee Q₁, XXXX

Q₁ is a trained beautician who worked in salons and taught in a technical college before starting as a franchisee. She established her business in 1983 as the XXXX Yves Rocher shop in XXXX. XXXX is regarded as a good location because of its holidaymakers. She has five full-time staff. The shop contains a salon.

Q₁ sees her obligation to Yves Rocher as total loyalty to the brand name. In return, she hopes for full managerial and marketing support. In addition, she believes the franchisor should monitor the network to control slack service quality. She would report any poor quality shop of which she became aware. This is because low standards are seen as having a detrimental effect on the value of the brand name.

Capital to start the shop came from a loan raised using her house as security. She is proud of her own risk taking in this respect. Moreover, she has a very clear understanding that most of her personal wealth was put on the line at the start of the business. She states that she could not have been more committed to success: "If it had failed then I would have lost everything". She has her own lease on the shop which is located just off the main shopping thoroughfare in XXXX.

The Agreement is described as being filed away. Q₁ claims that she cannot understand it and that it does not crop up in the normal course of events. She confirms the

structural details of the franchise reported by Mr. Navacelle and that the franchisor is not heavy handed in his dealings with her. She makes weekly sales returns and receives a visit from a field manager twice a month.

Q₁ is not aware of any territorial limit applying to her franchise. This is not consistent with Mr. Navacelle's statement that territories, which are based on location not sales, are linked to postcodes. She does believe that an understanding exists whereby the franchisee would be given first refusal over a nearby shop likely to compete with hers.

The franchise system appears to run trouble free for the most part. However, Q₁ perceives one problem area. Faulty goods may be returned to any shop for an exchange. The franchisee then receives a replacement item but no handling charge. Some franchisees refuse to make returns and customers then find their way to one, like Q₁, who does. This causes a lot of time to be lost on administering such returns. Q₁ feels the franchisor could enforce policy more strictly and prevent some franchisees from free riding in this way.

The main advantage of being a franchisee is the right to use the brand name. This is well known due to the size of the French network and the franchisor's advertising in women's magazines. Q₁ also feels that the initial support she received was excellent. She appears to be a little surprised to find herself successfully established in business, and seems pleased with the franchise system. Before she started she had seen an article in the Glasgow Herald reporting the better success rate of franchised new businesses.

Q₁ reports that her business returns are "Pleasing and as expected". Increased sales generally imply

increased profits in her shop. She intends to remain within the system and would like to open another shop if this were possible. Q₁ believes that the franchisor must have spent at least the initial lump-sum franchise fee in starting up her business.

2. Franchisees Q₂

Mr. and Mrs. Q₂ are both franchisees: Mrs. Q₂ began the XXXX shop in 1983 and Mr. Q₂ is currently setting up in XXXX (1987). Mr. Q₂ was previously a butcher in his family's business in XXXX, whereas Mrs. Q₂ was employed as a beautician before 1983. Mr. Q₂ has always been involved in his wife's business. Mr. Navacelle points out that in making each the franchisee for separate shops, his policy of not encouraging multiple franchises is followed. I interviewed Mr. Q₂ with respect to both businesses.

The XXXX shop is located just off XXXX XXXX in an arcade of jewellers and similar specialist shops. Five full-time staff are employed. The shop contains a separate beauty salon. The XXXX shop is being set up in the XXXX in XXXX and will have a similar format; it will be run by a manageress as it is felt important that customers should deal with a woman.

Mr. Q₂ believes that his obligations are to represent the Yves Rocher image adequately and to build up sales. In return, he expects good marketing support, prompt supplies and careful monitoring of the network. By good marketing support, he means that he expects quality advertisements in major women's magazines.

He confirms the structural details of the franchise reported by Mr. Navacelle. Mr. Q₂ also confirms that the franchisor does not quote details of the Agreement to him. He knows of no disputes within the system. Weekly sales

reports are made and a visit is paid by a field manager once a month. Mr. Q₂ understands that there are territorial limits, based on location, and that these are linked to postcodes.

Mr. Q₂ emphasises the benefit of trading under the brand name which he enjoys as a franchisee. Other benefits include the general support which the franchisor provides in areas like marketing and help in obtaining property leases. Both shops make use of head-lease arrangements through the franchisor; these are so arranged that rents must be passed on without additional charges. Mr. Q₂ regards the lease arrangements as a service provided by Yves Rocher and does not feel that they place additional controls upon him. He feels that he is able to offer the franchisor a much more committed local management than could be obtained from employed managers. He states that his business future is staked on the businesses.

The Q₁s are happy with their business returns. Increased sales generally imply increased profits. Despite recent tight trading conditions in the XXXX area, profits have stood up well. The Q₁s are sure that Yves Rocher spent more than the lump-sums they have paid in setting up their businesses. They intend to remain with the system.

Summary

Yves Rocher operates a chain of 30 franchised cosmetics shops. Franchisees buy tied-in products on which the franchisor makes his profits. Franchisees are in competitive local market conditions as they face competition from department stores and other specialists like Bodyshop. Franchisees' costs may be relatively fixed over likely sales ranges. The franchisor can be confident

that they will sell all that they can at or below prices that he recommends. The franchisor benefits from the local entrepreneurship of franchisees who have personal wealth committed to their businesses.

Head lease arrangements operate as a service to franchisees who are not obliged to use them. Rents must be passed on at cost. If a franchisee makes use of the arrangement he may incidentally give the franchisee the power to render all building and decorating costs completely sunk into the business: if the franchisee were to leave he might be prevented from adapting these to other uses. However the franchise fee, furnishings and decor which are specific to the brand, and professional fees represent heavy sunk costs anyway. The franchisee may not worry about sinking further costs providing there are benefits to him from doing so.

Franchisees benefit mainly from the brand name itself and appear well motivated and successful.

----- Subject to franchisee choice

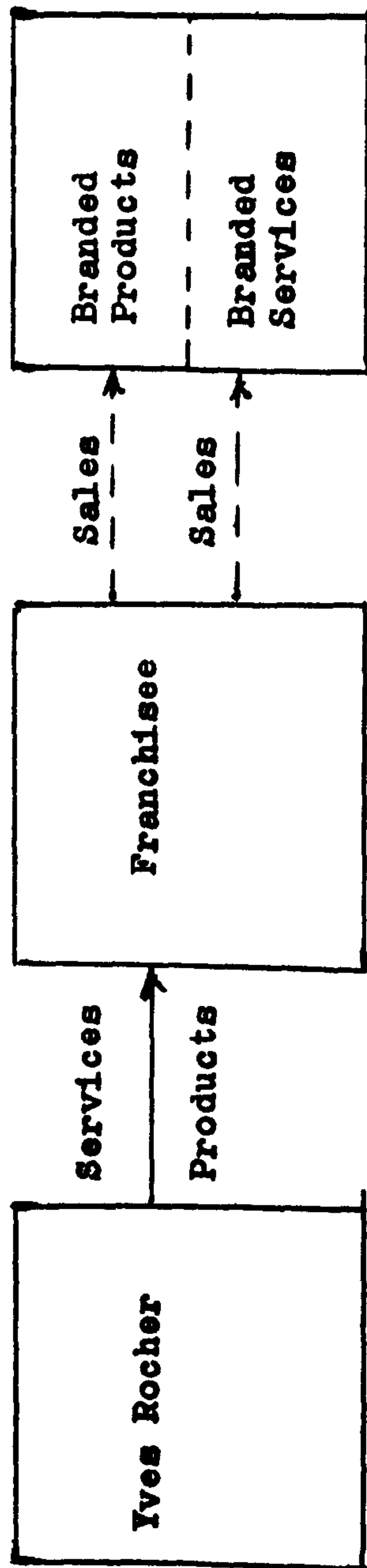


Figure Q Yves Rocher Franchise System

Appendix Q Yves Rocher set-up costs (£'000)

| | |
|---|----------|
| Franchise fee (design, plans, training and launch) | 7.5 |
| Building and decorating (Shopfitting, lighting, services provision) | 30 |
| Furnishing and decor (Yves Rocher units, signs and salon equipment) | 15 |
| Legal fees | 1.5 |
| <hr/> Capital costs (approximate) | <hr/> 54 |

Case R Austin Rover Group

The franchisor

1. Background

Austin Rover Group Limited is the car-making division of Rover Group Limited. Freight Rover and Landrover are the other main divisions which specialise in commercial vans and four-wheel-drive vehicles. Austin Rover (AR) is the descendant of the British Leyland Motor Corporation which was formed in the 1960s from the merger of Leyland Cars and British Motor Holdings. These companies in turn were an amalgamation of traditional British makes: principally Rover, Jaguar, Riley and Austin-Morris. A system of franchised car dealerships goes back to just after the first world war through the history of these makes. There are approximately 900 dealers in the AR network.

In the 1970s British Leyland ran into financial difficulties and began to receive public subsidies with the UK Government becoming the principal shareholder. In 1986, Jaguar was returned to private ownership. Over the course of the early 1980s many brand names were dropped. The result is that the current model range consists of Austin, Rover and MG cars. The company received poor publicity in the 1970s and early 1980s concerning poor product quality but is now confident that the slimmed-down model range, covering executive, family and sporting saloons overcomes old problems. AR is a major British car producer with around 18% of the UK new-car market.

Car dealerships are typically regarded as a separate form of franchising. AR, in common with other car makers, does not belong to the British Franchise Association. Instead, it belongs to the Society of Motor Manufacturers

and Traders. There is a dealers' association which acts as a franchisees' association.

2. Nature of the franchise

AR does not claim to provide a full business-format franchise for dealers. However, procedures covering most aspects of sales, administration and operations are detailed by the franchisor in manuals. In many ways it is difficult to detect much difference between this and the franchise manuals offered by acknowledged full business-format franchises. A significant difference is that AR does not claim to be able to take an inexperienced businessman and provide a total support package; instead trade experience is expected. Also, some aspects of the business are not covered such as used-car trading activities.

I interviewed Mr. Keith Field, AR's Scottish Area Dealership Manager at the company's regional headquarters in Glasgow. He believes that a franchisee's principal obligations are to exercise local entrepreneurship, to remain loyal to AR, and to achieve high standards of operation. In return, AR must provide cars that will sell, give full marketing support and provide back up over most of a dealer's activities.

A dealer trades under the AR brand name in new and used cars. He provides service facilities and stocks parts. The used car part of his business is not subject to controls from AR. According to Mr. Field, an exclusivity policy is followed so that, with very few minor exceptions, a dealer only has the AR name on his site. Multiple franchises are not encouraged where this would lead to a dealer controlling a number of contiguous sales areas. Dealers may have other brands on sites with which AR has no connection.

The dealer makes a brand-specific investment in signs, tools and service facilities. He does not take his lease through AR so that premises could easily be adapted to other retail car-sales uses. No professional-limitation clause operates in his Agreement, so he could always trade on his local goodwill if he left the AR network. The franchisor has discretion over whether to buy back specific assets like signs and tools if the dealer leaves; but a good second-hand market exists in most of these items anyway. Whilst it is not possible to be precise here due to a lack of data on start-up costs, it is likely that only a small part of any initial investment is sunk expenditure for a dealer.

AR provides a stock franchising system for franchisees, who must maintain vehicle stocks based on a 12-month moving average of their sales performance. The system is known as Wholesale Vehicle Finance (WVF). The moving-average annual number of vehicles sold minus fleet sales and demonstration cars is multiplied by a weighted average of vehicle prices to arrive at a total sales value. This is multiplied by 11% to provide the stock base for a dealer approximately equal to one and a half months' cover of sales. The dealer then pays variable interest charges on the stock base each month. The system is open to all distributors and main dealers, and to retail dealers who are judged financially sound by AR.

Distributors are large dealers who also supply cars to smaller retail dealers located in their sales territory. The distributor receives a handling charge from AR for this service. Main dealers are larger dealers without distribution responsibilities. Other than this detail, all dealers are on broadly similar contracts. Distributors also supply parts to main dealers.

Actual vehicle stocks do not depend on the charges levied by WVF for a particular dealer. Distributors, main dealers and retail dealers regarded as financially sound may order any stocks subject to vehicle availability and may hold them for 180 days without penalty. Thereafter they must return them to AR or purchase them at the wholesale price plus car tax and VAT. Smaller retail dealers have stock limits placed on them related to sales-targets. WVF charges are discounted by amounts related to the achievement of annual sales objectives. Dealers make their own financial arrangements to cover stocks of parts which they keep.

AR provides training for dealers and their staff covering sales, operating and administrative systems. Dealers pay their own travel and subsistence costs on this.

The AR franchise system is illustrated in Figure R where arrowheads show the direction of sales. The dealers' contracts limit their freedom to choose whether to supply any particular customer. Dealers may always elect not to use WVF if they wish instead to place deposits on vehicles ordered equal to the stock base described above. Distributors administer WVF charges applying to retail dealers.

It may seem that there is little difference between a system in which a dealer places a deposit covering one and a half months' stocks with the manufacturer and one where he pays interest on the same amount. In both cases he must tie up the same assets either to pay the deposit or to generate funds to pay the interest. However, the WVF system means that the assets are tied up elsewhere and are not locked in with the maker. The system was adopted in 1981 after pressure from dealers who were worried about the financial soundness of what was then British Leyland.

The interest-based WVF scheme means that large deposits are not vulnerable to manufacturer failure.

3. The contract

3(i) Agreements

AR uses a number of Agreements with dealers. These are straightforward and do not attempt to exhort the franchisee to practise good standards as is the case with full business-format franchising. A similar basic Dealer Agreement is used with distributors, main dealers and retail dealers with differences affecting areas where the distributor has a relationship with retail dealers. These aspects are the administration of WVF and stock delivery which have been discussed above. In addition to the basic Agreement there are separate Finance Agreements, Sale or Return Agreements and Minimum Standards Agreements covering each type of dealership.

The Finance Agreement covers WVF, which has been discussed. Sale or Return Agreements specify that dealers have 180 days in which to sell cars or else they must return or purchase them. Minimum Standards Agreements cover the parts stock, garage facilities and other details, such as demonstration fleet, which each type of dealer must provide. This section concentrates on the basic Agreement for a main dealer. A copy of this is available for inspection should this be required.

The Agreement confers the non-exclusive right to trade under the brand name in a specified location, for an unspecified period of time but subject to two-years notice of termination by either party. AR sets the dealer's territory which refers to location and marketing, not sales. The Agreement runs to 21 pages and 11 principal clauses.

It is precise over any area that is covered but does not try to deal with all possible eventualities.

Sales procedures are detailed. Vehicle registration procedures must be followed and the customer must be provided with relevant vehicle handbooks. Transfers of vehicles between dealers must be notified to AR. All technical or other information relevant to AR must be kept confidential by the dealer. Stock returns must be made at the times specified by AR. The dealer will trade exclusively in AR cars unless he has written permission to the contrary. Sales targets are to be set annually by the manufacturer in consultation with the dealer.

The franchise is not saleable as such. The dealer may sell his business but the AR franchise will only be transferred to the buyer if he meets AR's approval. This differs from similar provisions in business-format franchise agreements.

AR may bypass dealers in making retail sales; this enables centralised marketing efforts over fleet sales. Stocking conventions may be varied from time to time and the dealer must adapt to the changes. The dealer must service vehicles presented to him by owners of the make: his freedom to supply is limited here. He must also deal with any warranty claim whether or not he sold the vehicle to which it refers. Prices are recommended maximum prices which the retailer may freely vary.

The Agreement may be terminated by either party if he considers the other to have breached it. He must give notice of the steps necessary to remedy a breach and 20-days to correct matters. If one party becomes insolvent then the other may terminate the Agreement by notice alone. There is also freedom for either side to terminate with 24-months notice of the intention to do so.

If AR terminates under the 24-months procedure it must buy back unsold vehicles and parts, and brand-specific equipment. Prices are basically those paid by the dealer minus a wear and tear allowance in the case of special tools. However, if the dealer exercises his 24-months notice period, AR is not obliged to buy back the brand-specific investment. This condition acts as a deterrent to the franchisee's leaving in that it may be more costly for him to sell these assets on his own account rather than back to the franchisor. However, a completely sunk investment is not created; there are alternative markets for these items. If the contract ends the dealer must take down AR signs and cease trading as a franchisee.

The franchisor retains the right to create changes in the dealer's territory if he is thought to be performing poorly and has been notified of required changes which have not been made.

The dealer must cooperate with the manufacturer and with other dealers to promote the brand. Any dealer advertising material must be approved before it is used by AR.

There are the usual technical clauses: if either party fails to exercise a right it is not waived; clauses are severable, the dealer cannot act as AR's agent in the legal sense of proxy; and the Agreement is governed by English law. There is no requirement for compulsory arbitration.

3(ii) Implicit aspects of the contract

A number of implicit aspects of the contract between AR and its franchisees can be identified. These are

business understandings which are supported by the long-term value of the relationship to both parties.

Vehicles are transferred between the manufacturer and dealer at prices which broadly allow a 12% to 17% mark up on sales according to Mr Field. This amount is qualified by rebates on WUF which accrue if a dealer hits his sales targets. Sometimes there are special bonuses for achieving targets for particular models. These amounts are not specified in the Agreement and depend upon the franchisor's efforts to make profits subject to giving satisfactory returns to dealers. Retention and recruitment of franchisees will motivate AR in this area.

Mr Field states that in practice the exclusivity requirement does not apply to small rural retail dealers who could not make a living from selling one brand. These instances are rare but are not covered in detail in the Retail Agreement. In such cases AR values brand representation enough to waive the usual requirements.

Training is not covered in the Agreement. Franchisees generally regard this as worth its costs to them. They pay travel and subsistence costs whereas the franchisor pays for direct costs. The arrangement has arisen because of its mutual advantage without any need for provision in the Agreement.

3(iii) Enforcement and monitoring

Mr Field states that AR "Tries very hard to work to the Agreement". Dealers have a tendency to forget it and small violations do arise from time to time. These occur in areas to do with minimum standards or when dealers run advertising campaigns outside of their marketing areas. AR tries not to be too heavy handed in applying the Agreement. Normally exhortation is the starting point in

bringing a practice into line. This may be followed by a rectification notice in cases where dealers are recalcitrant; the notice procedure giving 20 days to rectify a fault is a feature of the dealership system. Termination is rare: Mr Field could think of only one recent case in Scotland where a dealer's contract was terminated for selling cars which really belonged to AR.

Dealers report their sales on a weekly basis. This is backed by use of the national vehicle registration system: all makers obtain details of new car registrations from the Driver and Vehicle Licensing Centre at Swansea. In addition, field managers are used occasionally to observe franchisees across all areas of their activities and to advise over any improvements that may be required.

Mr Field argues that AR is aware of the need to keep the franchise system working well from the dealer's point of view. There is nothing stopping a dissatisfied dealer from leaving except the reorganisation costs which he would face and limitations on the availability of other franchises.

An independent review of dealers' financial performance is carried out for AR by Intercompany Comparisons. Dealers who fall below average performance levels are advised of ways to correct matters. Participation in the scheme is voluntary.

4. Why franchise?

Mr Field states that AR could not consider selling cars through any outlet prepared to deal with them. This would lead to difficulties in ensuring that service levels were adequate. There would be a temptation to sell cars cheaply by cutting the full range of support presently provided. Dealers would then be unlikely to provide

quality showroom facilities, for example, knowing that customers may use them to obtain information or demonstrations and then purchase from cheaper sources. AR believes that quality services are worthwhile from the point of view of stimulating total demand. The avoidance of product-debasement externalities is an argument for running either a franchise system or company-owned showrooms.

A second advantage to AR of franchising is that the local trading expertise of dealers can be relied on. In particular, this refers to their dealings in vehicles which are traded in against new cars. A problem in handling part exchanges is that used-car values vary considerably depending on condition. An employed salesman has an incentive to overstate a trade-in value if he wishes to sell a new car. This may be controlled if the salesman faces consequences if he overtrades. It is thought that this is best controlled if he is employed by a local businessman whose profits depend on proper performance in this area. Also, this local man's knowledge may be vital to discerning what a vehicle will sell for. Mr Field points out that makers like Renault who have tried running their own showrooms have made losses on them.

Mr Field believes that dealers benefit from being able to trade under a maker's brand name. Their second-hand trading becomes more respectable in the eyes of purchasers if combined with a new-car showroom. In addition, there are whatever sales are generated in an area for new vehicles, parts and service. Many of these sales follow from the maker's national reputation.

Mr Field reports that AR did try an experiment in retailing in 1986. Asda ran a 12-car display in one of their supermarkets (on the Isle of Dogs in London) along

with a service operation carried out on another site. This failed after nine months in May 1987. The principal reason seems to have been that Asda did not develop the car-trading specialism that traditional dealers appear to possess.

Mr Field also perceives capital-raising advantages to franchising. AR is able to concentrate its investments where it has relative advantages: in car production and distribution.

5. Fees and returns

All returns to dealers come from their mark up of 12% to 17% on new car sales, their second-hand trading profits, and profits on parts, servicing and service-station operations. AR makes its profits from the prices of transferred tied-in products. A 1% loyalty bonus is paid on wholesale prices to dealers who do not attempt to bring other brands on to their sites during a year.

AR may vary transfer prices and WVF scales as means of extracting any economic rent arising at the retail end of the business. These are flexible means of doing this.

Sales targets are set annually for dealers. In principle, this enables AR to specify a quota of cars to be sold as well as the maximum price at which this is to be done. In the short term at least the practice of forcing could occur, where the dealer is made to sell beyond his profit-maximising price when this suits AR. In practice, this will be constrained by the need to retain dealers over the longer-term, unless all makers adopt exactly the same practice.

It is well known that AR has a recent history of loss making. It is similarly understood within the motor trade

that retail margins are very tight indeed on new-car sales for all makes. A typical annual profit rate on sales could be as low as 2%. Many motor traders went through a period of very bad returns between 1980 and 1983.

The franchisees

1. Franchisee R₁, XXXX of Scotland

R₁ is the Managing Director of the Scottish division of XXXX plc. In Scotland, XXXX is an AR distributor and main dealer, selling around 2,000 cars a year, with five showrooms. In addition, the XXXX and XXXX businesses carry Landrover and Jaguar franchises. This study concentrates on the XXXX franchise, which has the motor-trade site in xxxx.

XXXX's XXXX operation is an AR distributorship with full service and parts facilities for retail and motor-trade customers. There are XXXX retail dealers attached to XXXX who are based in surrounding urban and rural districts. There are approximately 50 full-time employees at the XXXX site. Jaguar sales, which used to be based on the same premises, have had to moved to a separate showroom since Jaguar's privatisation.

R₁ confirms the structural details of the franchise and also is able to clarify aspects of the contract between a distributor and AR. He states that whilst the franchise is not a full business-format one, it is becoming increasingly well packaged. The dealer is able to follow systems laid down by AR in most areas if he so wishes. AR pays a discretionary amount towards local TV advertising costs as it is keen to encourage dealers to use this medium. TV advertising is likely to have external effects on neighbouring franchisees.

An implicit aspect of the contract pointed out by R₁ is that cars are never returned to AR under the Sale or Return Agreement. Dealers feel that if they have not sold a car at the end of the 180-day stock consignment period then they must adopt it or transfer it to another dealer.

Warranty claims filed by dealers are an area which could suffer from fraud, according to R₁. In the AR system, standard job times are used to ensure diligence in carrying out of warranty work. Average error in times are subtracted from the entire job card by AR. This essentially obliges the dealer to be at least of standard efficiency or face some warranty costs himself.

XXXX takes part in the voluntary Intercompany Comparisons performance analyses. R₁ states that this is a beneficial service which helps him to identify areas of weakness. Visits from field managers do not have the character of monitoring checks but are more like opportunities for consultation. AR is not heavy handed in its interpretation of the Agreement according to R₁. He remembers no instance of it being quoted to an XXXX dealership.

The main advantage of belonging to the AR system is the right to trade under the brand name. XXXX has a long-established link with AR which goes back to the 1920s. R₁ points out that it would take a lot of dissatisfaction with the brand to disrupt this as the business is geared up to work for it. He sees no possibility anyway for a large garage to operate as an independent retailer with many brands on site. It comes down to choosing which brand and AR has XXXX's loyalty subject to retail profits holding up.

R₁ believes that the main advantage which a franchise system offers AR, given that control over service levels

is required, is that local trading skills are used to the full. He cannot see how an employee-based system could overcome problems of valuing trade-ins. In particular, he knows that XXXX has to be careful within well defined local dealerships to control salesmen's wishes to achieve sales targets by overgenerously pricing part-exchanged vehicles. R₁ also believes that over the years companies like his have become expert at trading and distributing.

XXXX is a profitable company which has weathered the 1980 to 1983 motor-trade recession well following some recent reorganisation. R₁ states that forcing is not a problem in the trade at present. The maker has built in incentives which cause dealers to wish to sell as much as possible at or below recommended prices. He does not feel that XXXX is forced to sell more than its profit maximising output. However, this would not be true without incentives like the rebate on WVF charges and occasional special promotional payments which accrue when sales targets are achieved. In the 1970s and early 1980s these payments were not available and traders complained of forcing.

2. Franchisee R₂, XXXX, XXXX

R₂ is a Director of XXXX, an AR main dealer based in XXXX. The business is relatively new having been started in 1979 as a retail dealership in Glasgow. The move was made to main-dealer status in 1986 when AR decided to offer the area around XXXX to him. This was a change that R₂ was pleased to make as he felt that AR's policy was to reduce the retail network to consist only of small country garages; in the longer term he believed that his city retail set up would not have been required.

The garage offers a range of new and used cars, repair services and a parts service. All new cars come

direct from AR and there are about 50 in stock at any one time. Annual new-car sales targets are currently around 300 cars. A minimum parts-stocking agreement means that 2,500 separate lines must be kept on site. The site employs 19 people.

R₁ confirms the structural details of the AR franchise system reported by Mr. Field. In addition he agrees that the franchisor does not regularly quote Agreements to him. In general, reward structures are designed to ensure that it is in the dealer's interest to sell as many cars as are supplied at or below the recommended retail price.

R₁ sees his obligations to AR as achieving sales targets and maintaining service standards. In return, he expects brand development, stock availability and marketing support. He comments that the support received when moving his dealership was very good and almost amounted to the kind of start up help given in full business-format franchises.

R₁ takes part in the Intercompany Comparisons performance analyses and finds these a useful check on his efficiency relative to the rest of the network. He makes weekly sales returns. He sees AR field managers about once a month and regards their visits as consultative rather than monitoring exercises. There are occasional disputes within the network; none have affected him and usually they are over model availability or sales targets.

The dealer gains respectability for his used-car operations and AR business on parts, service and new sales in an area by belonging to the network. R₁ feels it is not feasible to attempt independent trading in the new-car business. It is a question of choosing between brands on the basis of returns and the availability of a territory.

The manufacturer benefits from more committed local entrepreneurship by using a dealer network, according to R₂: "There is a more personalised service due to me having my money invested in the business".

R₂ is happy with his profits which are "At least as good as the other makes". A few years ago, when AR was in difficulties with its model range he thought of exercising his option to quit giving two-years notice. He is now much happier with the range and no longer has this intention. He comments that a dealer would face high costs in switching maker. Most makers have exclusivity policies and a fairly fixed number of territories. Finding a new franchisor may mean also moving location which may sacrifice some assets attached to the existing site; in particular, it might prove difficult to transfer local goodwill elsewhere.

Forcing is not considered a problem these days due to incentive schemes which increase the dealer's profits the more he sells.

3. Franchisee R₃, XXXX, Edinburgh

R₃ is Dealer-Principal of XXXX, an AR retail dealer located in Edinburgh. XXXX is R₃'s distributor. XXXX is an old family firm which was established in XXXX and which first took a franchise with Wolesley in XXXX. There are 21 employees in this garage which sells around 100 new cars a year. About three times as many used cars are also sold.

R₃ believes that he has two obligations to AR; he must keep to his Agreements and maintain service standards equal to the rest of the network. In return, he expects new models to be developed at suitable intervals and for cars to be delivered on time. He confirms the structural

details of the franchise reported by Mr. Field and states that the franchisor is not heavy handed in interpreting Agreements.

This dealer prefers to lodge a deposit with XXXX rather than incur WVF charges on new-car stocks. At any one time 35 cars are likely to be stocked. The preference for the older method of stock funding may reflect simple inertia on the dealer's part. Alternatively he may have no worries about lodging capital sums of around £65,000 with a respectable local firm like XXXX. R, gives no account of his reasoning.

Sales returns are made weekly. In addition, R, participates in the Intercompany Comparisons performance analyses and finds these useful. He is visited at roughly two-month intervals by AR field managers who mainly advise over workshop matters.

R, feels that the main benefit of being an AR franchisee is the respectability which is added to his operations, particularly on the used-car side of things. His long association with the company "Makes it easier to deal with them". He also benefits by being able to obtain some specialist tools which would otherwise be hard to buy. He believes AR benefits from his local trading knowledge.

A retail dealer like XXXX has no territory as such but is located, along with other retail dealers, within the marketing territory of the Distributor. R, complains that in his area three dealers are located within a few miles of each other. AR would like more of a spread but no-one wants to move. R, would prefer more leadership in these matters.

R, confirms that forcing does not occur at present: given the incentive structure, it is most profitable for him to sell all that he can at prices at or below those recommended by AR. This all changed around 1983. He feels at the moment that he could be more profitable with a different maker and looked at some in the early part of 1987.

Summary

AR uses a franchised dealer network to sell cars with associated services like repairs and parts stocking. All profits derive from transfer prices on tied-in sales for AR. Incentives are carefully chosen to ensure that dealers sell all that they can at or below AR's recommended prices; the incentives are either special rebates or rebates on WVF which are linked to sales targets.

Franchisees who act as distributors, main dealers or retail dealers, receive modest returns in comparison with other retail activities on their new-car sales. However, a dealer's respectability is enhanced by trading under a maker's name and this helps his used-car sales and his servicing work. It may partly be returns on these other activities which explain dealers' preferences for taking a franchise.

AR benefits from the local-trading expertise of franchised dealers and has a marked preference for operating in this manner. At the same time, a franchised network enables standards of sales service and repair work to be monitored and controlled.

----- Subject to franchisee choice

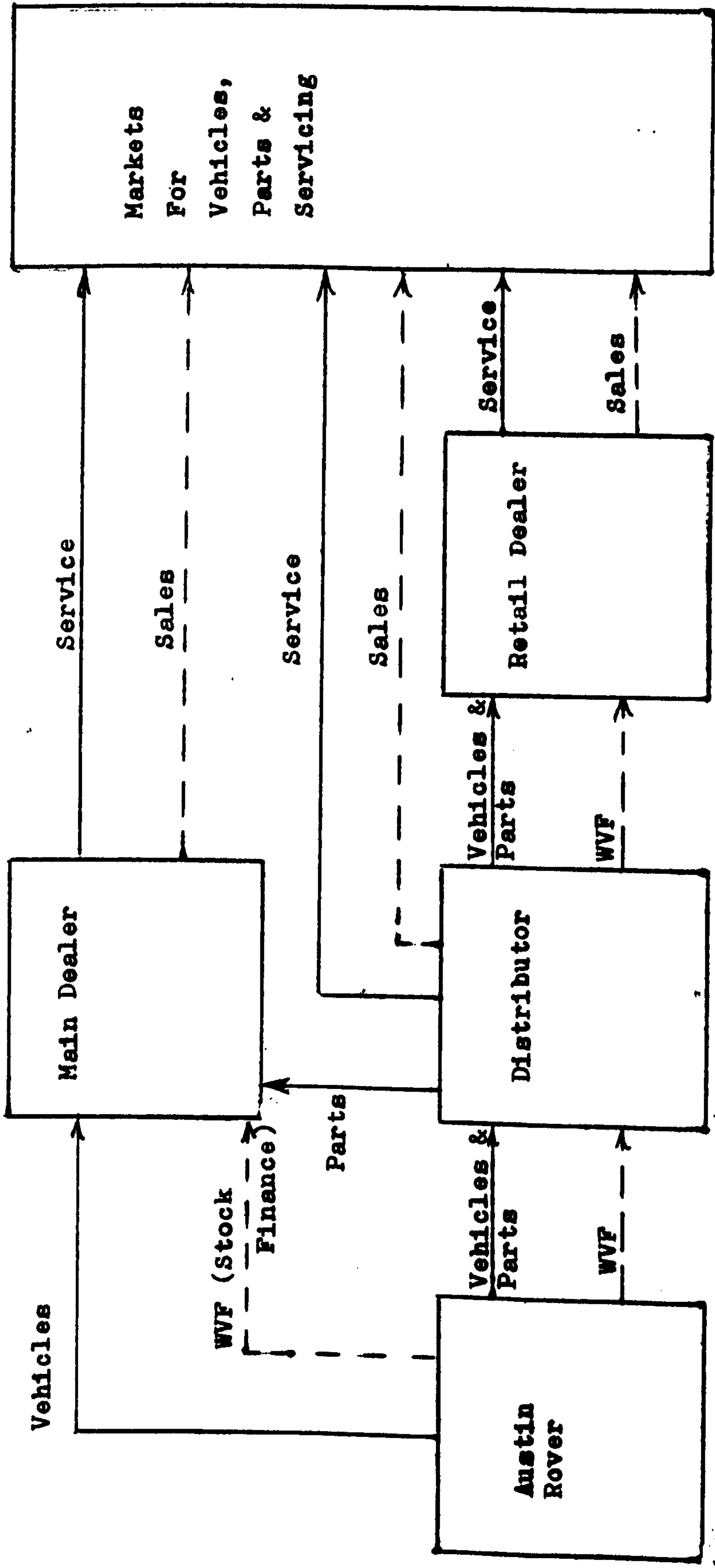


Figure R Austin Rover Franchise System

Case S Ford Motor Company LimitedThe Franchisor1. Background

Ford entered the UK market in a major way after 1950. Franchising policies developed in the 1960s as Ford moved towards being the UK's major car producer. Ford is organised into five regional divisions: London and the South East; the North; the Midlands; the South West; and Scotland and Northern Ireland. The company produces a full range of cars and light and medium-sized vans. Truck production is not well developed although a recent joint venture with IVECO may change this (1986). This case study concentrates on Ford's retailing of cars. Ford has around 25% of the UK new-car market.

Ford has a two-tier distribution network of franchised dealers. There are 390 main dealers together with 350 smaller retail dealers. Main dealers buy cars and parts directly from Ford and sell to retail customers; they also act as wholesale distributors to any retail dealers located within their area of responsibility. Ford does not like fractional or multiple franchise arrangements and has a policy of not allowing franchisees to develop chains of dealerships. Fractional franchises very occasionally arise in remote country districts where Ford wishes to be represented but where any one brand would not provide an adequate income for a dealer.

In common with other car makers Ford does not belong to the British Franchise Association. Instead it is a member of the Society of Motor Manufacturers and Traders. There is a dealers' association which acts as a franchisees' association.

2. Nature of the franchise

A dealer sells new and used vehicles, provides service facilities and stocks Ford parts at his site. Retail dealers are small country or suburban garages whereas main dealers tend to be located in larger population areas. Parts are bought outright using whatever financial sources are available; in 1986 average parts stocks were £125,000 a garage. Cars are bought on sale or return subject to a deposit scheme.

The Bulk Deposit Scheme (BDS) used by Ford requires a main dealer to pay 13% of his 12-month moving average sales (minus fleet sales) to Ford. Each month he then pays to or receives from Ford a sum which maintains this percentage. He may stock up to six times this amount. Vehicle consignment periods are for 180 days after which they must be either returned to Ford or purchased by the dealer. It is intended that cars should be sold within this period. If a vehicle is bought by a dealer at the end of its consignment period, no adjustment is made to the BDS charge. Main dealers administer the system for retail dealers. The BDS is not characterised by significant vehicle returns or dealer adoptions. Ford Motor Credit, a separate Ford-owned company may be used to finance stocks.

Dealers pay their own local advertising costs and pay charges for training which is provided by Ford. Sometimes there are subsidies for local advertising. Training covers sales, administration and workshop matters and is provided at less than market cost, according to Mr George Tilley, Ford's Regional Director for Scotland and Northern Ireland.

Ford does not aim to provide a full business-format franchise yet it does supply a comprehensive

package of guidance for dealers. Manuals exist covering sales, administration and maintenance procedures. Plenty of support and advice is available more or less free of charge.

Ford does occasionally run its own showrooms. An area may be under-represented in Ford's view: perhaps a dealer dies and his business closes or possibly population movements occur. Ford will then invest in a Dealer Development Site (DDS). The intention here is to bring a site up to commercial viability and then to sell the business to a franchisee; the buyer usually moves into the DDS as manager and then gradually buys out Ford's interest over time. The DDS system demonstrates Ford's preference for running its retail system through "Owner-driver franchisees", as Mr Tilley puts it.

The Ford retail network is illustrated in Figure 8 where arrowheads show the direction of sales flows. Dealers must provide parts and maintenance services for Ford vehicles, so their freedom to choose whether or not to supply any particular customer is constrained.

3. The Contract

3(i) Agreements

Ford uses a Sale or Return Agreement and a Dealer Agreement with its franchisees. Versions exist for both retail and main dealers. The Sale or Return Agreement covers the BDS which is described above. This section gives a brief outline of the principal clauses of the Main Dealer Agreement (henceforth 'the Agreement'). A copy of this is available for inspection should this be required.

The dealer agrees to purchase vehicles and parts for sale in his Dealer Area of Responsibility (DAR). The DAR

may contain retail dealers for whom the main dealer takes wholesaling responsibilities. The DAR is defined as a marketing area: the dealer must not advertise outside of it but may sell cars to customers regardless of their location. The dealer accepts annual sales targets which are to be agreed with Ford at the start of each year. The Agreement is of open term but is subject to two-years notice of termination from either party at will.

The Agreement requires the dealer to promote vigorously the sale of vehicles and parts. In setting sales targets, Ford may use its sales forecasts for the DAR. The dealer must employ trained service staff and must keep service equipment and parts stocks which are agreed with Ford from time to time. Ford will advertise nationally at its discretion. The dealer undertakes to subject his own advertising to approval by Ford. He also agrees to keep a fleet of demonstration vehicles specified by Ford for his franchise.

The dealer undertakes to train his staff using Ford's training materials. He also agrees to operate Ford's warranty system in his DAR. Unless Ford gives permission to the contrary, no competing products may be sold by the dealer in his DAR. No more than five DARs may be operated by one dealer (under separate Agreements) and none of these may be contiguous areas.

The Ford Agreement contains clauses which exhort the franchisee to do his best as in the case of the ones covering sales which are quoted above.

Ford may terminate the Agreement with immediate effect if the dealer acts fraudulently, becomes insolvent, dies or becomes incapacitated, or changes the ownership of his business without consent. In all other cases of contractual breach by the dealer, at least 90-days notice

must be given during which time he has the right to rectify the complaint.

The dealer may terminate the Agreement with immediate effect if Ford becomes insolvent or persists in any contractual breach after a warning has been given. If Ford fails to provide spare parts, technical services or vehicles in a manner which prevents the dealer from meeting his agreed sales objectives, or fails to pay monies owed to the dealer, and notice in writing has been given by the dealer twice within a 12-month period, then the dealer may also terminate the Agreement.

Should the Agreement be terminated, the dealer must pay all debts to Ford and cease trading under the maker's name. He must stop dealing in Ford products at the site. Ford may choose to buy back equipment specific to the make along with unused stocks of vehicles and parts. There is nothing compulsory about this purchase so that Ford could leave a dealer with the task of disposing of such items on second-hand or similar markets. If parts and vehicles are repurchased it is at current list prices; vehicles are unlikely to be owned by the dealer. Disputes over the valuation of equipment are to be settled by an independent valuer selected by Ford and the dealer. There are second-hand markets for these items so there is a limit to the amount of a dealer's initial investment that could be made sunk by this means.

The dealership may not be sold by the dealer. He may sell his business but Ford is free to choose whether or not to accept the purchaser as a franchisee.

The price list published by Ford is to be interpreted as recording maximum prices for the dealer's sales. If more is charged then damages must be paid to Ford. These amount to one-half of the price of a vehicle or three

times the price of a part sold above the recommended prices. A further penalty clause fines the dealer £500 for exhibiting vehicles, and £100 for exhibiting parts, outside of his DAR.

Any disputes arising from the Agreement are to be settled by compulsory arbitration. The arbitrator may be appointed by the mutual consent of the dealer and Ford. If they cannot agree then the President of the Law Society appoints an arbitrator in England. In Scotland, the Arbitration Act of 1894 may be followed to appoint an arbitrator. In England, the Agreement is governed by English law. Agreements which are signed in Scotland are governed by Scottish law.

There are a number of technical clauses: non-exercise of any right does not constitute its waiver by either party; the dealer is not legally the agent of Ford; and clauses are severable. The Agreement is relatively straightforward and does not attempt to cover every eventuality.

3(ii) Implicit aspects of the contract

A number of business understandings have grown up in Ford's franchise system. These rely on the long-term value of the franchise relationship to one or both parties for their support and may be regarded as implicit aspects of the contract.

It is understood that the return option of the Sale or Return Agreement is rarely exercised by dealers. If they do not sell a vehicle within its 180-day consignment period, it is either adopted at the dealership or transferred to another dealer who is looking for such a model. S, states that he has never known the return option to be exercised. Dealers go along with this rather

than disrupt smooth relations with Ford. The implication of a return is that a sale has not occurred for the maker and Ford does not want this.

Items like the minimum parts stock, service provision, the stock of vehicles and levels of dealer advertising are incompletely specified in the Agreement. These levels must satisfy Ford's market strategy subject to leaving the dealer at least the return he could make elsewhere on his assets. Otherwise franchisees would not be retained in the longer run. Ford's level of national advertising is not specified either; this must be adequate to reassure dealers that the cars will sell, which is a result that Ford will anyway wish to achieve.

Prices are augmented with bonus schemes for the dealers from time-to-time. Exact pricing details of this kind are not specified in the Agreement. The strategy chosen must leave dealers with at least normal returns or else they will not be retained in the long run.

3(iii) Enforcement and monitoring

Mr Tilley states that Ford does not enforce Agreements in an heavy-handed manner. Agreements are only occasionally quoted over serious infringements such as advertising outside of a DAR. Ford aims to build up a good management relationship with dealers and relies on this in conjunction with dealer loyalty to run the retail network.

Sales figures are reported by dealers at least weekly. Tied-in sales act as an automatic check on these as does the national registration of vehicles at Swansea. Registrations are reported to the SMMT and thence to manufacturers as a matter of course. The relevant monitoring for Ford is of standards of service and of

brand loyalty. Occasionally visits by field managers during which advice is given to dealers act as a check on standards and on any bootlegging.

A system of voluntary reporting by dealers of their business performance, the Business Management Return, is operated by Ford. Participating dealers receive a comparison between their figures and relevant averages.

Generally, the network runs smoothly, according to Mr Tilley. He knows of no terminations of any Agreements. Just occasionally a dealer "Has his knuckles rapped" by Ford over territorial incursions or perhaps use of non-Ford parts. Mr Tilley believes that Ford is good at maintaining incentives so that the dealer network wishes to fit in with the maker's plans.

4 Why franchise?

Mr Tilley believes that Ford keeps its brand image as it wishes and maintains service levels by franchising its dealer network. There is no intention of moving away from the owner-driver model of a family owned dealership as an ideal although the matter has been reviewed several times. In particular, he believes that an alternative like selling through supermarket chains would cause a reduction in the model range which would be stocked and that this would be detrimental to overall sales.

The limited size of most dealers' businesses means that garages become specialised in their local markets. This has important consequences for Ford. Mr Tilley states "Ford is good at marketing, logistics and production. We don't sell cars; that's the dealer's job". Ford draws on local entrepreneurship in two main areas: trade-ins are valued and sold at proper market prices, and local demand can be better assessed. Ford's production is

adaptable through model variations to local market conditions. Local men use their knowledge to order their stocks allowing production to be better geared to demand. Mr Tilley believes that franchised dealers have a lot at stake giving them an incentive to get their trading right.

Mr Tilley believes that franchisees benefit from the brand strength of Ford. The returns on new-car sales, parts and servicing are in themselves valued by dealers. In addition, their used-car trading is made more respectable because they trade under the Ford sign.

5 Fees and returns

Ford levies no initial lump-sum franchise fee nor any sales royalty. All maker's profits come from the transfer prices of vehicles and parts. These may be varied to alter the distribution of any economic rent arising at the retail end of the business. Ford is a major UK company and is currently profitable.

Mr Tilley reports that Ford has a definite view of the desirable level of profitability for dealers. Prices are regarded as market determined. Wholesale transfer prices aim to give a 17% gross margin to dealers. When a dealership is opened, it is expected to yield at least a 25% return on investment (profit per unit of original capital employed). The Business Management Return is used to check the performance of different types of franchisees. Too low a return leads to worries that dealers will leave the network. Sales bonuses to dealers may be used to help dealer financial performance.

Current dealers' returns are not particularly good, according to Mr Tilley, but they are improving.

The Franchisees

1. Franchisee S₁, Edinburgh

S₁ is the Managing Director of XXXX Limited, an Edinburgh-based Ford main dealer. The company is owned by its parent, XXXX, and was founded in 1900 as a bicycle dealer. XXXX began as a Ford franchisee in the late 1940s. 100 staff are employed at the Edinburgh business which sells around 1,400 new cars and vans each year. In addition, used cars are sold, a full service facility is offered, parts are stocked, and a car hire business runs on the Edinburgh site. Three retail dealers are supplied by XXXX.

S₁ sees his obligations as "very wide". The dealer's job is to provide the service levels expected of a major car maker and to achieve sales targets which are set each year. In return, S₁ expects a full back-up service from Ford in areas like marketing and technical training. He also expects poor quality dealers to be brought up to standard by Ford to prevent erosion of the brand image.

This dealer confirms the structural details of the franchise system reported by Mr Tilley. In addition, S₁ is able to clarify some aspects of the contract. He uses Ford Motor Credit to finance his BDS charges but points out that he is free to use any finance source that he wishes in this area. Training is paid for by XXXX (at below market rates) but grants are available from the Road Transport Industry Training Board to which dealers pay a levy. Local advertising is left to S₁'s discretion without attempted interference.

S₁ states that Ford is a strict interpreter of the written Agreements. It is "Not advisable for a franchisee to bend the rules". Persistent poor performance, for

example in meeting sales objectives, leads to a Ford survey and improvement plan. The dealer is then given a lot of support for a period at the end of which termination would occur if improvement was not obvious. However, S₁ agrees with Mr Tilley that terminations are rare. Also, he does not experience regular quotation of his Agreements. The main implicit contractual aspect recognised by S₁ is the understanding that vehicles are not returned.

Disputes occasionally arise in the dealer network. From time to time there have been accusations of forcing levelled at Ford by dealers. However it is now the case that incentive structures, with sales bonuses, imply that the dealer increases his profits by maximising his sales. Sometimes dealers try to use non-Ford parts and are disciplined by Ford. The general pattern is that disputes are settled if they are general in their effect following discussions between Ford and the dealer association. Specific problems with one dealer are normally successfully controlled by exhortation from Ford.

S₁ believes that the main advantage of belonging to the Ford network is the ability to trade under the brand name. The product is strong in the UK market having a reputation for good design and easy servicing. Sales are good and are backed by excellent central marketing undertaken by Ford. Another advantage to Laidlaw is the increase in respectability conferred on used car trading. Higher prices can be charged for used cars when a buyer feels assured about the quality of his purchase.

Ford benefits from XXXX's local market knowledge, according to S₁. He suggests that "Ford are in a different business; they make cars!". The arrangements are seen as very convenient to Ford who can concentrate on manufacture without needing to develop retailing skills.

XXXX is a profitable dealership although return on sales is no higher than the industry average at around 2% (operating profit as a percentage of sales turnover). S₁ is committed to the Ford network and has no intention of seeking other franchises.

2. Franchisee S₂, Edinburgh

S₂ is Managing Director of XXXX of Edinburgh Limited, a subsidiary of XXXX. XXXX has a long history of association with Ford. In 1908, Ford supplied cars to XXXX for sale in Scotland. The company appointed numerous sub-agents who grew to become main dealers in their own right in time. Presently, XXXX has four main dealerships: Edinburgh; XXXX; XXXX; and XXXX. This case study concentrates on Edinburgh.

XXXX offers a full range of dealer facilities: sales of new and used cars; servicing; and parts stocking. Approximately 80 staff are employed across the range of activities. Current new-car sales targets are 1,500 units a year. There is no responsibility for retail dealers.

S₂ believes that his principal obligation to Ford is to provide a quality local sales and service operation whilst achieving sales targets. In return, he expects support from Ford over the marketing and development of the product. National advertising should create continuing brand awareness among consumers. The product should remain competitive in every way with those of major competitors.

This dealer confirms the structural details of the Ford franchise system reported by Mr Tilley. Ford gives good sales, operations and administrative support and advice. S₂ does not use Ford Motor Credit to fund his BDS

charges but uses an independent credit company; Ford has no objection to this. He is able to clarify aspects of the contract, viewed from a dealer's perspective. Ford require a dealer to submit his building and location plans for approval at the start of a venture; this appears to be an implicit aspect of the contract. S₂ recognises that the return option of the Sale or Return Agreement does not really apply. He also expects that Ford should not be too heavy handed in interpreting Agreements.

S₂ reports that Ford generally lives up to his expectations. There is no continual citing of Agreements in his dealings with Ford. Rather, "Ford shows a big-brother attitude". If practices occur which Ford wishes to change it generally proceeds by exhortation. S₂ states that it is important that dealers think they can trust Ford: it is always open to Ford to invoke contractual breaches to terminate an Agreement if it so wishes. Ford has no history of that kind of behaviour.

XXXX participates in the Business Management Return and finds feedback from this useful. Sales are reported weekly and automatically reinforced by registrations at Swansea in the case of vehicles. Ford managers visit the dealership roughly every month in an advisory capacity; this also acts as a monitoring device. If deficiencies are identified, Ford sometimes identifies key personnel whose performance must be improved.

S₂ is aware of some disputes in the dealer network. These normally arise over the use of non-Ford parts, bootlegging of cars or advertising outside of the DAR. A dealer bootlegs if he sells an unauthorised make or sells through unapproved channels. Ford does not use arbitration to settle such issues: the typical use of exhortation is normally a sufficient control.

The main benefit of being a franchisee is the ability to trade under the brand name, according to S₂. The brand is currently strong in the market and generates plenty of sales and service work. S₂ agrees with S₁ that the Ford name helps used car sales to be more respectable. In return, S₂ believes XXXX offers local trading expertise which Ford would not otherwise possess.

XXXX is a profitable dealership in Edinburgh, although returns are around the average of 2% return on sales (operating profit as a percentage of sales turnover). There is no intention of seeking alternative franchises.

3. Franchisee S₂

S₂ is Dealer-Principal of XXXX, which is a Dealer Development Scheme (DDS) garage in the process of moving from Ford's ownership. He is also XXXX in Scotland. XXXX has been a problem area for Ford; the dealership was run down prior to 1981, when S₂ took over under the DDS. Ford bought the dealership and recruited S₂ who had been working as a sales manager for a Ford dealer. Over the following six years, profits accruing to Mr. Inglis have been used under the Scheme to buy out Ford's interest in the business. This process is now complete (1987).

XXXX acts as a main dealership with responsibility for one retail dealer in XXXX. A full range of service facilities are offered alongside new-car and used-car sales. Around 800 new Fords are sold each year. 55 staff are employed.

S₂ sees his obligations to Ford as maintaining standards at least equivalent to those elsewhere in the network and meeting his sales targets. In return, he expects "comprehensive support" covering sales, operations

and administration. Ford has performed well for him particularly as he has been on the DDS. He confirms the structural details of the dealer system reported by Mr Tilley and can clarify the operation of the DDS.

During the period of operation of the DDS, Ford management sat on S₃'s board of directors. Also, audits were taken of sales and service activities every three months; these would normally occur every three years for a regular dealer. Advice was always available from DDS personnel of Ford. S₃ did not find Ford to be continually quoting his Agreements during this period. Rather a management relationship was built up which allowed him increasing independence as the six years progressed.

S₃ confirms that the main benefit of being a franchisee is the market strength of the Ford brand name. He believes that his sales and service receipts are higher than would be the case with any other make in his locality. He also states that his used-car trading is made more respectable by the Ford sign over the site. Ford benefits from his local trading knowledge which has developed over recent years. S₃ believes that he has every incentive to use this as his business future is tied up in the business: "Ford must value this or they would not operate the Scheme".

Returns are not yet good on the XXXX site, according to S₃. The business receives support from Ford. S₃ is committed to his business as it is planned and does not contemplate moving franchises.

4. Franchisee S₄, Ford retail dealer

S₄ became a Ford retail dealer in 1985 having previously worked as a mechanic and then as a garage manager. When he bought his garage, which is sited just

outside XXXX, he succeeded in retaining the Ford franchise with which its previous owner had been associated. He has sales targets of around 40 new cars a year, sells at least 50 used cars each year and runs service and parts operations on the site. A total of 14 people are employed.

S₄ sees his obligations to Ford as meeting his targets and providing an high quality service operation in his area. In return, he expects a full back-up from Ford, particularly over technical matters and in terms of rapid parts supply. His principal benefit from being a dealer is the volume of service business which he obtains, particularly where this is attached to company and fleet cars. He states that little profit arises on his new-car dealing and that he has difficulty meeting targets. His used-car operations are small and he cannot say whether they benefit from their location on a franchised site. He describes support on the service and parts side as "excellent".

A XXXX garage, XXXX, is S₄'s main dealer. XXXX is responsible for supplying parts and vehicles to S₄. The main dealer is also the first point of contact over technical matters.

S₄ reports that he has been in dispute with Ford. Ford have complained that he has not met his sales targets on new cars and threatened to remove his franchise. In 1987, S₄ actually sold some new cars at a loss to himself to ensure that he retained his franchise. This was because of the benefits that he perceives on the servicing side of his business.

A retail dealer's commitment to the Ford network is explained by the sales revenue which the brand name generates, according to S₄. Specialised tools and parts

are another factor. He has around £12,000 worth of these. If he were to move franchise, or had his Agreement terminated, he would recoup only one-quarter of these costs. Much of his personal wealth is sunk into the business.

S₄'s business is a busy small garage on the main Cambridge to Oxford route. He is very much the Ford model franchisee in being personally involved in the running of the garage and showrooms.

Summary

Ford uses a two-tier system of franchises to distribute its products whilst providing a full service back up for the customer. No lump-sum franchise fees or sales royalties are charged by Ford whose profits accrue from the wholesale prices of products. Ford has a preference for a franchised dealer network and even subsidises the establishment of dealers in poorly represented areas through a Dealer Development Scheme.

Ford benefits from the local trading skills of franchisees, which would be difficult to replicate in a fully integrated network. Compared with open sales to retailers, franchise restrictions preserve service facilities. Dealers benefit from trading under the Ford name; these benefits include the respectability that a maker's name confers on used-car sales.

This franchise system relies largely on using financial reward structures for franchisees to keep their interest compatible with those of Ford.

----- Subject to franchisee choice

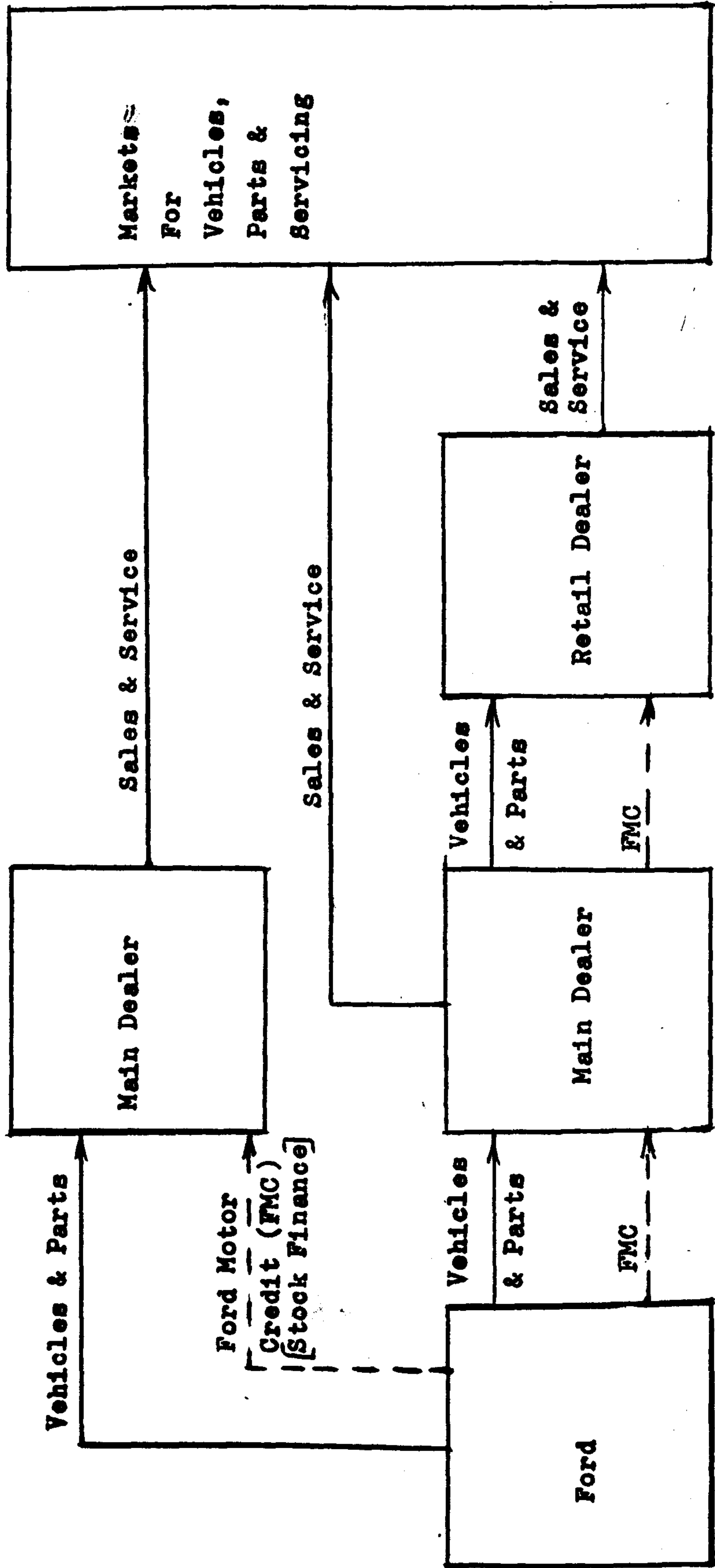


Figure 8 Ford Franchise System